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ACTUAL GROSS INCOME *vs.* TAXABLE GROSS INCOME UNDER 1934 ACT

INTERPRETATIONS *of* RULES *for* LISTING *and* ISSUANCE OF SECURITIES

THE ADMINISTRATION *of the* C. P. A. LAW *in* NEW YORK STATE

IMPORTANT INCOME TAX DECISIONS *of the* PAST YEAR

VITAL NEED *of* PRIVATE EXAMINATION *of* BANKS

NEED *for* EXAMINATION *of* BANKS *by* ACCOUNTANTS

IMPORTANT CHANGES *in the* 1934 REVENUE ACT

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Actual Gross Income vs. Taxable Gross Income Under 1934 Act

By WALTER A. M. COOPER, C. P. A.

IN starting the first part of our 1934 tax conference, I desire first to compliment our committees for the type of program they have arranged. Too often tax meetings are devoted to a discussion of particular problems, decisions or rulings, without sufficient attention being paid to the principles and theories underlying tax procedure in general. If we have a better understanding of the fundamental theories, we will be able to appreciate to a greater degree the basis of many of these decisions and to apply them to different circumstances and facts, instead of being limited to the tax treatment of the particular item of expense or income involved in each decision.

Those of you who have been concerned with income tax practice for a number of years will recall that when income taxes first began to receive serious consideration (about 1917 when the first high-rate tax law was enacted) the law was administered largely by accountants or persons accounting-minded. Our first Advisory Tax Board was composed largely of accountants. We were all inclined to regard taxable net income and true net income in the accounting sense as being rather synonymous. It was not long, however, before technical problems developed and we began to realize that we were operating under laws containing specific provisions relating to gross income and deductions which did not necessarily produce true income from the accounting point of view. Naturally, many disputes arose and a number of them reached the courts in tax proceedings of various types.

For quite some time, the courts and the Bureau of Internal Revenue were inclined to decide these problems on a strictly legal basis. This tendency produced some obviously inequitable results and during the past ten years there has been a gradually widening tendency to inject accepted accounting principles into the consideration of disputed points. In some instances this has resulted from recognizing the realities of a situation, with which we accountants are so much concerned, rather than confining consideration strictly to legal precepts. Whatever the causes, we seem gradually to be narrowing the gap between accepted good accounting practice and proper tax procedure.

Unfortunately, however, we have a long way to go (if we ever get there) and as many of our older precedents are still wholly legal concepts, and some not quite so old are the result of attempts of persons, who have no understanding of accounting principles, to apply them, our present procedure is most involved.

Congress has also further complicated the matter by writing into our tax laws additional departures from accounting principles, either by exempting what we would normally regard as income or disallowing true deductions. As a result, we have reached the point where taxable net income may differ

quite materially from what we, as accountants, would say is the true net income of the taxpayer.

Theories Underlying Determination of Taxable Gross Income

The subject of gross income to be considered is a rather broad field to explore. It will not be possible here to outline and discuss the large number of items of gross income which may be treated differently in a statement of taxable income from the manner in which we, as accountants, would treat them in an income statement. Nevertheless, there are some fundamental theories underlying the determination of taxable gross income and I shall try to trace some of them through our income tax law. If we understand them fully, we are better able to advise our clients and to prepare their tax returns without the need of keeping at our finger tips, if we could, the thousands of decisions in tax cases, each involving some particular item of income or expense.

In our accounting practice, we do not feel that in order to render satisfactory service we must have studied, or had experience with, every type of business or accounting problem. We school ourselves thoroughly in basic principles and then apply them to the different facts and circumstances as they arise. So far as possible, we should do the same thing in tax practice. Some accountants, however, make no attempt to do so, thinking perhaps that one must know all the cases and rulings or, worse, do not recognize that tax accounting may differ from accepted accounting principles and apply the latter erroneously.

If I can aid you to recognize some of the basic principles running through our tax procedure, to understand the whys and wherefores, and not merely the result or conclusion, and to analyze your particular tax problems on that basis, I shall feel that my efforts have been well spent.

I shall not attempt, at this time, to recite in detail the provisions of section 22 of the Revenue Act of 1934 which defines the meaning of the term "gross income". It should be sufficient, for the purpose of this talk, merely to recall that it is very broad and includes almost every type of income from every conceivable source.

The differences or variances between taxable gross income and what we would call true gross income in the accounting sense may be classified, roughly, into four different groups:

1. Those resulting from constitutional limitations on the rights of the Federal Government.
2. Those resulting from specific exemptions allowed by Congress either:
   (a) To facilitate Federal Government operation, or
   (b) For the purpose of equitably easing the tax burden in cases where transactions result in profits but leave the taxpayer either without the cash with which to pay the tax and/or with an interest in the same or a similar asset.
3. The differences resulting from a strict application of a particular method of determining taxable income, each year standing by itself.

4. The differences resulting from a prior election to use a particular method which the law requires be continuously used thereafter, unless permission to change the method is first obtained from the commissioner of internal revenue.

Some of the types of variances I have mentioned merely result in changing the year in which income is taxed, but taxable income and true accounting income over a period of years will be the same. However, with tax rates changing and with losses of one year not being carried into succeeding years as offsets against such later years' income, you can readily appreciate that the year of inclusion may make a substantial difference in the tax liability.

Constitutional Limitations; Interference with State Powers

The first group of variances resulting from constitutional limitations on federal powers has two general bases:

1. That the Federal Government shall not interfere with the conduct of state business or state government by the several states or their sub-divisions.
2. That Congress, without apportionment among the several states, may tax only what is truly income and only so much thereof as accrued after March 1, 1913, prior to which date it did not have the right to tax income without apportionment.

I might point out here that there are no such limitations on deductions, as Congress can allow no deductions if it so desires.

With these principles in mind we can understand readily why the law exempts interest on obligations of a state or territory and sub-divisions thereof, including the District of Columbia, and salaries of their officers and employees. To do otherwise would interfere with the state's borrowing power and impair state's operating efficiency. Nevertheless, such items do constitute real income and we accountants could not support the exclusion of the same from any accounting statement of income. Carrying that thought further, it becomes logical to hold, as the Bureau of Internal Revenue now holds, that the discount at which such obligations are issued likewise is exempt when realized by the holder. Thus accounting principles, which recognize discount as being just as much part of the cost of borrowing as is the interest, are injected into the interpretation of law. That principle has been further extended to exempt such interest and discount even when realized by the holder of the bond through a sale thereof to another, under which circumstances the state does not pay anything direct to the vendor. Discount in such cases is prorated on a straight line basis, not a funded basis, over the life of the security. If the discount actually realized by the purchaser and seller is greater, then the balance is treated as a taxable gain; but if less, then only the amount actually realized is exempt.

Following the same principle, we exclude, in determining taxable income, real income in the form of salaries paid to officers and employees of states or sub-divisions thereof, for the performance of essential government functions. The cases generally require that the services rendered by the recipient

be in the nature of a continuous employment rather than a single, isolated task and be rendered in accordance with state law and under state control as distinguished from an independent contractor who may be given a specific job to perform or result to accomplish but keeps within his own control the manner and means for its accomplishment.

The Significance of March 1, 1913

The fact that Congress first obtained the right to tax income, without apportionment, on March 1, 1913, results in excluding from gross income a number of items which we might normally include in income. As you know, the Federal Government prior to the date had no right to tax income without apportioning the tax among the states according to population. As a result, any income accrued or appreciation in value of property owned on March 1, 1913 is not subject to tax even though it was not then due or payable and may be realized or recorded many years after 1913. This exemption applies to accrued interest, accrued salaries, royalties, damage claims and other claims, the right to which definitely accrued and became established prior to March 1, 1913 even though the amount thereof might not have been definitely determined on that date. The principal problem, from a tax point of view, in connection with this phase of our income tax procedure, lies in determining whether or not the right to the income or asset, particularly damage claims, infringment claims, etc., or appreciation definitely existed on March 1, 1913. Although it may be rather difficult to reconcile one or two decisions of lower courts with the general theory, the majority of cases involving that question seem to apply quite definitely to the principle that if the right to receive property definitely existed on March 1, 1913, even though it was not then payable, or required a court action to make other parties recognize the right and determine the amount thereof, the proceeds are not subject to tax. Of course, if the right to recover depended on some subsequent fact or happening rather than on facts known or knowable on March 1, 1913, it becomes taxable.

What is Income

We cannot leave the subject of differences between true and taxable income based on constitutional limitations without some reference to the dicta of the court as to what constitutes income in the broad sense. Most of us are familiar with the general definition laid down by the Supreme Court in the Eisner v. Macomber case, namely, that "in general income is the gain derived from labor, capital, or from both combined." To be subject to tax, therefore, a receipt must constitute income in that sense; not the broader sense of being any receipt even if it results from a legal right and is not a gift. On the basis of this principle, our courts and the Bureau have held that many items constituting real income to the recipient are not subject to tax. Thus we do not include in taxable income damages received for personal injuries or sickness, for alienation of affections, slander, libel, breach of promise and similar income. We also exclude alimony. One of the more

recent additions to this class of exempt income is that of the income received by a widow from a trust or an estate in return for her release of her dower rights in her husband's estate. Income of this type is now held to be a return of capital, of which the widow became possessed at the time of her husband's death until the full value of that right has been recovered. Amounts in excess of that value represent gain and are taxable.

Also under this phase of constitutional limitations fall the problems relating to transactions by a corporate taxpayer in its own stock or the liquidation by any taxpayer of its own debts at less than par.

It has long been recognized that if a corporation issues its own stock for, say, $100 and settles that obligation by paying only $90, the $10 is not the result of labor, capital or both. Hence, it was held non-taxable. Until a few years ago, practically any transaction involving, at one end, a participant's own stock was non-taxable. Recent cases, however, have held a corporation may be taxable on receipt of its own stock, such as in the case of reacquiring its own stock in settlement of a damage claim which, if settled in cash, would have resulted in taxable income.

This year the Bureau of Internal Revenue issued a ruling holding that transactions by a corporation in its own stock may give rise to taxable income depending on the circumstances. Unfortunately, it is one of those broad, wide-open rulings that may be interpreted almost any way until court decisions have established its limitations. Undoubtedly, however, the test of whether or not the credit resulting from the transaction is a gain derived from the use of labor or capital, or both, will be of prime importance.

The same is equally true of forgiveness of indebtedness or its cancellation for less than par. Apply the test and we find that forgiveness or release because of inability to pay is not the result of using capital or labor. It is not taxable. On the other hand, having available capital, the repurchase of an obligation not yet due for less than face value produces a credit that results from using capital. Hence, it has been held taxable.

Contractual Relationships Facilitated Federal Operation

Our next group of variances results from exemptions specifically included in the law by Congress for the purpose of facilitating Federal Government operation. These are the exemptions in whole or in part of interest on federal obligations or obligations of corporations created under acts of Congress as instrumentalities of the government. These exemptions are matters of convenience for the Federal Governmnt to aid its financing programs. Except as to interest on obligations issued prior to September 1, 1917, which is wholly exempt, such interest is exempt only to the extent provided in the acts authorizing the issuance of the securities. The basis for this lies in the fact that the government, or its agent corporation, having issued securities all or partially tax exempt, a contractual relationship has been established and cannot thereafter be altered by later acts of Congress. So we have to turn to many other acts of Congress to determine our taxable gross income. There are too many government and agency corporate issues

to attempt to discuss them in detail at this meeting. Full details are readily obtainable in various tax services. In passing, however, it might be noted that in cases of limited exemptions each member of a family is entitled to the full limit of exemption, even though they file a joint return, and that, with respect to corporations, while most of the interest on these obligations is exempt from normal income tax, most of it is subject to excess profits tax under the Revenue Act of 1934.

Equitably Adjusting the Tax Burden

The next group of variances covers the specific exemptions resulting from the desire of Congress to equitably adjust the tax burden among various types of taxpayers. One of the more important of these is the partial exemption of profits on the sale or exchange of capital assets. These profits, under the 1934 Act, may be only partially subject to tax, depending upon the length of time they have been held by the taxpayer. This partial exemption is applicable only to individual taxpayers (directly or through partnerships, estates or trusts) and does not apply to corporate taxpayers. Such profits are taxable 100 per cent if the capital asset had been held for not more than one year, eighty per cent if held for more than one but not more than two years, sixty per cent if held more than two but not more than five years, forty per cent if held for more than five but not more than ten years, and thirty per cent if held more than ten years. Note particularly the following:

1. The asset must be a capital asset, which is defined as being any asset not inventoriable and not acquired primarily for sale in the course of a trade or business.
2. The period determining the per cent taxable ends on the last day of the year of ownership, the law defining the periods as *not more than* one, two, five or ten years.
3. The gain must result from a sale or exchange. A redemption of a bond by the debtor is held to be a sale or exchange for determining the creditor's tax liability but gain on redemption of stock through distributions in liquidation is 100 per cent subject to tax regardless of the period the stock was held. Losses on liquidation, however, are only partially deductible in accordance with the table.
4. Option sales all fall in the one year class.

If the property sold was acquired in connection with an exchange on which gain or loss was not recognized, and pursuant to which the securities or properties received take the same basis as those given up in the exchange, the assets received are deemed to have been held from the time the property exchanged was first acquired. Likewise, if the property was acquired under circumstances requiring the recipient to use, as his basis, the basis of the prior owner, the period held includes the period the asset was owned by the previous holder as well as that of the recipient. In cases where stock or securities were received as a distribution and no gain was recognized to the distributee, under section 112 (g) of the Revenue Acts of 1928 and 1932, and on stock dividends and rights, the period during which the taxpayer is deemed

to have held the stock so received on such distributions will include the period during which he held the stock with respect to which he received such distributions. In cases involving wash sales, as the result of which a loss was not allowed as a deduction because of the repurchase of similar securities, the new securities will be deemed to have been held from the time the original securities, on which the loss was disallowed, were first acquired.

Through all these specific provisions as to the length of time held runs the same theory, namely; that when gain or loss is not recognized on a transaction and the new property acquired either takes the basis of property given up, is merely a division of property previously owned, or a new owner is required to take a prior owner's basis, the period is dated back to the time when the first asset was acquired by the first owner. There is, however, an important exception to this general rule. That is the case where a loss is disallowed because of a sale to a member of the family or a personal corporation, in which case the other member of the family cannot date the period of acquisition back to the date of acquisition by the first member. This is clearly a penalty provision attempting to stop so-called tax-avoidance loopholes and is an understandable exception to an equitable exemption.

When True Income is Excluded from Gross Income

In the so-called reorganization or exchange section of the law, section 112, we find a number of cases in which true income is excluded from gross income. In many such cases, we might not regard the apparent profit as true income in the accounting sense. In some, however, we would treat the gain as an item which may properly be included in true gross income. A discussion of this section of the law might easily consume an entire volume. For the purpose of this presentation, I shall refer but generally to the subject and classify briefly the types of profits that are not subject to tax. They are: (1) profits resulting from the exchange of property, other than securities, held for productive use or investment; (2) profits resulting from exchanges of securities in connection with corporate reorganizations, as defined in the law; (3) gains from the transfer, under certain circumstances in which control continues in the same persons, of property to a corporation in exchange for securities of the corporation; and (4) gains resulting from involuntary conversion through destruction, theft, seizure, fire, or the exercise of the power of requisition or condemnation, provided the proceeds resulting therefrom are immediately reinvested in similar assets replacing those lost in the manner described, or if not immediately expended for that purpose, are so set aside, under the provisions of the regulations, for the establishment of a replacement fund, and later expended for similar assets.

Following this theory through the law, we then find that where the profit is not taxed on an exchange or transaction which, except for the specific exemptions of the law, would give rise to taxable income, it follows that on subsequent sale the basis for determining the profit goes back to the cost of the original property or the prior owner's cost. For accounting purposes, true income would have to be determined on the basis of the actual

cost to the then owner rather than on the basis of the cost to some previous owner and, again, our true net income would be different from income for tax purposes.

In connection with the exemption of exchanges we might, at this time, note a decided tendency of our courts, in the last year or two, to apply narrowly these tax exemption provisions. This, seemingly, is based on the general precept that when Congress has first stated in a law that a receipt of property gives rise to taxable income, as it does in section 22, the requirements of subsequent provisions granting exemptions therefrom must be complied with strictly.

Falling under the equitable adjustment for the tax burden theory are the specific provisions taxing insurance companies on a basis entirely different from other types of taxpayers. So does the exemption of the proceeds of life, health and accident insurance policies, and the partial exemption of annuities to the extent that the annuity exceeds three per cent of the cost thereof.

I will not discuss the provisions relating to insurance companies as I believe most accountants are little concerned with that subject and it will be more profitable to deal with other phases of taxation.

According to the discussions in Congress early this year, the provisions of our law prohibiting the filing of consolidated returns, except by railroads, also are based on the theory of equitably adjusting the tax burden. That, at least, is debatable, and certainly no accountant could say honestly that the true income of an affiliated group can be determined by recognizing and including all gains and losses on inter-company transactions, but, equitable or not, it is now the definite law of the land.

Application of Section 45 of 1934 Act

Less definite in its application, however, is section 45 of the 1934 Revenue Act which gives the commissioner of internal revenue rather broad powers to reallocate income and expenses of related and affiliated businesses. Note that its application is not limited to corporations but applies, also, to unincorporated businesses. The extent to which the commissioner may upset inter-business transactions and the extent to which he will attempt to do so has been the subject of much discussion in tax circles during the past year. If transactions are affected between companies at market prices, no problems will arise. In many cases, however, there are no similar arm's length transactions with outside parties and, hence, no definite indications of market prices. Furthermore, many subsidiaries are financed, or have some operating expenses paid, by their affiliated companies and these are important elements in determining the propriety of inter-company prices. It is in the case of such companies that problems will arise.

Naturally, it is probable that, if any possible change will result only in reducing taxable income of one company and increasing that of another, and neither is in the excess-profits tax bracket, no change will be made in the total tax and the commissioner is not likely to attempt to reallocate in-

come or expense. When the total tax might change, the subject should be studied carefully. The danger has resulted in the abolition of many subsidiaries. Unfortunately, however, I have noted a tendency on the part of some who do not appreciate the significance of this section of the law to feel that any sort of transaction will do. No one can state with authority what will be attempted and, if attempted, that what the courts will sustain will depend on all the facts and circumstances of each case. For the moment, one can only study those facts and use one's best judgment.

In connection with this subject of consolidated returns, or rather the present prohibition thereof, I have one further thought worthy of attention. When consolidated returns were filed in prior years, it was necessary to sign an agreement accepting the provisions of the consolidated returns regulations. These provided that if, in a later year, separate returns were filed, the inter-company inventory valuation (excluding inter-company profit therein), used as the closing inventory on the consolidated return, must be used as the opening inventory on the following year's separate return. The closing inventory in the first separate return, to the extent that it consists of purchases during the year, which in most cases will be the major portion, if not all of it, must be valued at cost which includes the inter-company profits. On this basis, the year's profits of that company will include, for tax purposes, not only the normal profits on sales of the year which will appear in its book income, but also the inter-company profit in the opening inventory which that company never would reflect in its book income. Likewise, the combined income of the affiliated companies will be in excess of true income.

It has been suggested that, because the failure to file a consolidated return for 1934 is caused by the act of Congress rather than by the taxpayer's voluntary action, this article of the regulations may be inapplicable. That is certainly equitable, but as the commissioner of internal revenue has issued no ruling or regulation, I am calling attention to the plain language of prior regulations so that one will have the possibilities in mind.

Strict Application of a Particular Method

We come now to a consideration of the differences between true income and taxable income resulting from the strict application of one of the methods of determining taxable income. These affect single years only as, over a period of years, there will be no difference between the total taxable income and true income.

Although our law provides that income may be recorded on the basis regularly employed by the taxpayer, provided it truly reflects net income, the administration of our law has developed several well-defined methods of tax accounting. Recognized in the regulations, they are the cash basis, the accrual basis, the installment sales basis, the long term contract basis, and, finally, the so-called farm inventory basis. Our principal troubles result from the fact that whichever method of accounting is adopted must be consistently followed and applied to all items.

Some accountants have been too much in the habit of preparing income statements on a proper accounting basis for clients or their bankers and then transferring the same to a tax return, even though it may reflect some items on a cash basis and some on an accrual basis, and properly so from an accounting point of view.

Most of our variances under this classification relate to expense deductions, but the principle is equally applicable to gross income.

Cash and Accrual Bases

Generally speaking, we know that the cash basis is recognized, for tax purposes, in many cases in which we, as accountants, would not regard the difference between cash receipts and disbursements as reflecting the true income. Nevertheless, such a basis not only is permitted but is required to be followed strictly with respect to all items of income and expense.

The test seems to be the question of the degree to which income of any year may be distorted. The income may be based on cash received or constructively received, if it is available but not accepted merely as a matter of convenience, less disbursements, taking all items strictly on that basis even though such a method distorts the income of a single year, provided it does not distort the income all the time to such an extent that the method can be said to be one not truly reflecting net income. In other words, does the cash basis distort income in one year by reason of particular events, but is generally fairly accurate, or does it always decidedly not reflect true income? That is the test.

It is in the application of the accrual basis, however, that the greater number of differences occur. For tax purposes, all income must be included in gross income in the year in which it accrues, although, for accounting purposes, we might consider it not only proper but essential to defer the inclusion of part of that income because of some unsettled contingency. A striking example occurs in the case of contracts requiring some future guarantee. Where experience shows that these future guarantees undoubtedly will involve the taxpayer in some further cost under the contract, we would consider it essential, from the accounting point of view, to defer a part of the apparent profit to cover such probable future cost and, hence, would not reflect in income the total gross profit. For tax purposes, however, we must reflect the full profit, regardless of the possible contingencies surrounding the guarantees under the contract.

Another illustration is the treatment of foreign exchange or assets relating to foreign transactions. In the case of American taxpayers operating foreign branches, the Bureau of Internal Revenue permits the valuation of current assets in such foreign branches at the rate of exchange prevailing at the close of the year and determination of the profits from foreign operations on that basis. If, however, a taxpayer should not operate a foreign branch but, nevertheless, has foreign transactions, the taxpayer is not permitted so to determine the profits from such foreign transactions on the basis of the closing exchange value for the foreign assets but must use cost.

Another illustration involves taxpayers engaged in selling a product in containers which are charged to the purchaser but are returnable, and experience shows that many, if not the majority, of containers are returned. In such cases, the taxpayer is required to include in gross income, for tax purposes, the sale prices of all containers so charged to customers, despite the fact that they may be returned later and the sale price charged to the customer is in excess of the cost to the taxpayer.

The requirement with respect to securities (of others than dealers) that the first-in, first-out method be used in the absence of identification and the refusal to recognize the average cost basis is another illustration of our difficulties. The extension of this technical theory to short sale transactions is another one. If a security trader holding in his box 100 shares of stock costing $1,000 sells through a short account 100 shares of the same stock for $5,000, he realizes no gain subject to tax.

Collections on Disputed Claims

Perhaps the greatest difficulty arises in connection with collections on various types of disputed claims which are settled finally either in or out of court. Generally speaking, the established principle seems to be that the item accrues as income in the year when the right to receive it became fixed finally either by court decision, which can no longer be appealed, by agreement of the parties, or by action of Congress, such as in the case of Mixed-Claims Commission Awards. It seems to be immaterial in most cases, if at that point the amount was not determined finally if the dispute involved the liability rather than the amount. Whether the total amount received or receivable is taxable or whether any cost may be applied against it, is another phase of this most complicated subject. The result depends so much on the circumstances of each case, and they can involve so many different things, that an extended discussion is not possible here. Suffice it to say that merely because we, as accountants, might defer including such an item in income until it is received, recognizing that in these disputes most anything might happen before the money is collected, does not warrant automatically reflecting it in the tax return for that year. Perhaps it should be included in the return for an earlier year, when a loss may have been sustained or tax rates were lower.

For a number of years, the Bureau of Internal Revenue held that all income which accrued during the taxable year should be reflected in gross income on the tax return, regardless of the probability of its ultimate collection. During the past few years, however, as the result of several court decisions, this provision has been modified somewhat to the extent that such items are not now required to be included in gross income unless there is a reasonable probability of their being collected. Perhaps taxpayers and the Bureau may not always agree on what is a reasonable probability of collection but nevertheless we find here an illustration of accounting practice modifying legal principles. I hope it will continue, but until it has been extended to a true accounting basis, we must apply to each item of income

the test of when the right to it accrued, or if the cash basis is used when it was received, constructively or actually, and reflect it in the tax return covering the year that it happened.

Installment Sales Method

The inclusion in our income tax law of specific provisions recognizing and permitting the use of the installment sales method of accounting is another evidence of the gradual recognition by law of good accounting principles. Yet even here true income may differ from taxable income. One cause is the specific limitation, in the case of a casual sale of personal property or a sale of real property, that the installment sales basis may be used only if the initial payment does not exceed thirty per cent of the selling price. As accountants, naturally, we place no such limitation on the use of the installment sales basis to reflect correctly true net income.

The principal difference between taxable income on the installment basis and true income on the same basis lies in the provision of the Revenue Act of 1934 requiring that on the disposition of the installment sales obligation the unreported profit becomes taxable, even though that disposition may involve the receipt by the holder of no consideration. This, of course, is a provision to prevent tax avoidance.

Under this provision, if a corporation should dispose of an installment obligation by way of liquidation, transfer to an affiliate, or to a stockholder as a dividend, the unreported income becomes taxable to the extent of the value of the installment obligation. Likewise, if an individual holder of such an obligation makes a gift of it or dies, the profit becomes taxable at its then market value. With respect to death, however, it is provided that if the recipient, executors or beneficiaries provide a bond that they will pay the tax on the profit on later collections as though the original holder retained possession, no income becomes taxable at death. One could not call it good accounting to say that the act of giving something away for nothing, or death, could create income but it does under the tax law.

Another variance results from the specific provision of the law requiring the inclusion in income on the installment sales basis, in the case of a change from the accrual basis, of the proportionate part of *all* collections representing profit regardless of the fact that in the prior year, on the accrual basis, the accrued profit was already reported as part of the taxable income, thus duplicating the same income. Naturally, if we were preparing accounting statements for a client who already has reflected in surplus, on an accrual basis, the profit on an installment of a prior year, we could not add to that surplus another profit on the same sale.

Theory of Estoppel

We should not leave this phase of the subject without making some reference to the tendency of the Bureau of Internal Revenue, during the past few years, to apply the theory of estoppel. On that basis it attempts

to tax income in an admittedly incorrect year because it was not taxed in the prior correct year, against which the statute of limitations has run.

This is an attempt to overcome the limitations of the law with respect to the strict application of a method of determining income. It has not been applied, however, to deductions, and prior year deductions are still disallowed even in cases where the Bureau refused to allow them in the year now alleged to be the correct year.

An attempt has been made to overcome this situation in the Revenue Act of 1934 by providing that if a taxpayer should fail to include in a tax return an amount in excess of twenty-five per cent of the gross income shown on the return, which means twenty per cent of the correct total gross income, the statute of limitations is extended to five years. The extension of the period of limitations to five years will not dispose of all such problems because some cases will involve substantial amounts of income but not as much as twenty-five per cent of the gross income reported on the return, and in others the facts regarding the omission of income may not be developed until after the expiration of the five-year period. Neither will it dispose of years prior to 1934.

The extent to which the Bureau of Internal Revenue may go in taxing income that, so far as the merits of the case are concerned, should not be included in the return for the year involved is now in the process of determination. By reason of some rather favorable decisions several years ago, the Bureau seems to have extended materially the scope of the theory of estoppel. One or two recent cases have been somewhat less favorable, but so far they are all lower court or Board of Tax Appeals decisions. In the course of time, the Supreme Court will, no doubt, pass upon a sufficient number of such cases to establish fairly definitely the extent to which the theory of estoppel may be applied. It is now of such importance, however, that we may well spend a few moments considering the general circumstances which may make the theory of estoppel applicable. They require that the taxpayer shall have made a definite statement of pertinent facts relating to the taxability of items of income and that the Bureau of Internal Revenue, relying on the taxpayer's statements and claims, reached a conclusion and closed a prior year case, only to find that when the question of taxing the income in a later year arises the taxpayer contends that the amount properly was taxable in the prior year. In other words, there should be a definite holding out by the taxpayer to his own advantage upon which the commissioner relied. To illustrate what I have in mind, if a taxpayer reporting on a cash basis excludes income in a prior year, and in support thereof states that it was not available and, therefore, not constructively received, so that the Bureau of Internal Revenue approved the prior year tax return without including such item in income, I believe such a taxpayer might well be estopped from stating with respect to the year in which it was received that it was available and had been received constructively in the prior year and hence was not taxable in the year of receipt.

The Bureau of Internal Revenue has sought to apply the theory of estoppel to almost every case in which income was not reported in a prior year, even though the facts may have been readily available to the representative of the Bureau of Internal Revenue who examined the records. But if an item of income were omitted under a mistaken conception of law that it did not constitute income, and that position was well taken, the income in question should not be taxed in a later year if it develops by reason of court rulings that it was excluded erroneously in the earlier years, and that occurs after the statute of limitations has run against assessment for that earlier year.

The principal question as yet undetermined with respect to the estoppel theory is the effect of the taxpayer's failure to make any statement on the prior return directing attention to the fact that the income has not been included in the return. This failure might be innocent or otherwise. Eventually, no doubt, we will have definite expressions in Supreme Court opinions that will clarify the present confused situation. For the time being, however, it would seem desirable to resist all attempts, except in clear cases, to include income in an improper year on the grounds of estoppel.

Continuing Methods Once Adopted

Another group of variations between true income and taxable income results from the requirement of the Bureau of Internal Revenue, or the law, that certain methods of accounting once adopted must be followed consistently each succeeding year unless permission to change the method is obtained from the commissioner of internal revenue and that permission is requested the required length of time prior to the close of the taxable year.

From an accounting point of view, we are of course not limited to the use of a particular theory or method if it does not reflect true income. We also know that one method might well reflect true income for one or more years and then be incorrect in another year. Foremost among these is the method of determining the value of the inventory. As long as market values are maintaining an upward tendency, the cost basis of inventory valuation may well reflect true income. However, should there be a decline in market values it may become then necessary to use the cost or market value basis to determine true income. If our adopted basis were cost, the cost or market basis would not be permitted for tax purposes, unless permission had been obtained to change the method even though the need therefor did not develop until shortly before the close of the tax year and after it was too late to request that permission. Some taxpayers have found that a definite advantage during the past few years as it has permitted them to value their inventory for tax purposes at an amount in excess of the value shown in their accounts, because the latter recognized decline in market values while the tax return did not. Thus, they have reported on tax returns smaller losses and have retained a higher basis so that, when the years of profitable operation arrive, and the closing market values are no longer less than cost, a smaller taxable income will be reported.

The continued use of either the accrual or, more particularly, the cash basis may also result in an income that is not true income. In my earlier discussion, I dwelt on the application of either basis to all items of any year. An equally untrue result may be obtained from the continued use of either basis, as which ever basis is adopted must be continued year after year, even though conditions have changed, unless permission has been obtained to make a change. As that permission may be predicated on duplicating items of income or losing the benefit of expenses, it may not be desirable to request it. That should not prevent changing the book accounting method but tax returns must still be prepared on the old basis.

In closing, let me summarize this subject in a few short sentences:

1. Taxable income and true income are not synonymous.
2. We seem to be partially on the way towards making them the same, though I doubt that we will ever reach that point.
3. Most of the differences result from the application of fundamental theories or principles, to wit:
   (a) Constitutional prohibitions
   (b) The desire to equitably adjust the tax burden
   (c) The requirement that whatever basis be adopted must be applied strictly to all items, and
   (d) The requirement that methods once adopted must be followed in later years.
4. If the basic theories and reasons therefor are fully understood, it will permit of the reasoning out of many problems, or recognition of their existence, without keeping thousands of decisions or rulings, and particular law provisions at finger tips.

No treatment of this length could ever give a full knowledge or understanding of the subject covered. That requires considerable study and application. But if it starts the reader thinking the right way so that, as his problems arise, he examines cases or reads the regulations, he analyzes them and stores the knowledge thereof in his mind along the lines of basic principles instead of as interest, sale, compensation or what not, it will have accomplished its purpose.

From an address presented at the 1934 conference on income taxation of the New York State Society of Certified Public Accountants.

Interpretations of Rules for Listing and Issuance of Securities

By Dr. James M. Landis

A REASON makes me particularly happy to have the opportunity tonight to address the New York State Society of Certified Public Accountants and its guests. It arises from the fact that about a year ago I had my first opportunity to address the profession of accountancy through this Society. The federal securities legislation had then only been initiated, and the regulation of stock exchanges was merely a hope and not an accomplished fact. In talking to you then I tried to give you a sense both of the objectives and the mechanism of the Securities Act of 1933. But more than this, I appealed to you as representative of a financially vital and significant profession that, whatever our differences in detail might be, our objectives were the same and that government and the accounting profession should unite to make firm those objectives and iron out their differences as to detail. That appeal, I am happy to say, did not fall on deaf ears. We convinced you and you convinced us that we could work together earnestly, harmoniously and effectively.

Indeed, the subject of this presentation to you tonight, the recent corporate reporting regulations promulgated by the Commission, is in large measure the product of that joint effort. I want to speak with some particularity to that theme because it seems to me illustrative of two things, the procedure that our Commission has established towards approaching these new and difficult problems, and the attitude of professional and semi-professional groups towards the efforts of government in this and I hope many other fields. Words like "cooperation" have lost much of their meaning by their employment to describe situations that have only the pretense of joint effort and not its real content. But none of this pretense, none of these casual conferences, characterized the type of help that we received from a group of accountants representative of the American Institute of Accountants, the American Society of Certified Public Accountants, and your own Society. Instead, the story is one of long days, and long nights of work. On our side your reports and your memoranda were considered carefully; on your side, our series of tentative drafts were subjected to severe and weighty criticism. In many matters we were convinced by your arguments and in some matters we convinced you. It was an experience which, I know, we enjoyed, but more, from which we learned to know and respect each other. I cannot pass this by without publicly expressing thanks for your generous effort and your wise contributions.

My subject, as I have indicated above, concerns the recent regulations promulgated by the Securities and Exchange Commission dealing with the character of the reports that corporations shall file as a condition either to their issues being registered on a national securities exchange or as a condi-

tion precedent to the issuance and distribution of new securities. As you know, the Securities Exchange Act of 1934 empowers the Commission to prescribe the type of listing requirements that shall govern on the various stock exchanges of this country. These listing requirements are to become effective on July first of this year, supplanting the temporary scheme for listing which was introduced last October. The first series of these requirements was promulgated a few days before Christmas and is known as form 10. This is to be used for all corporations whose securities are now listed on an exchange with certain specified exceptions, such as railroads, banks, insurance companies, foreign corporate bonds and the like. The second series, promulgated today under the Securities Act, is known as form A-2 and is the form to be filed by all corporations which have earnings' records for at least three years and have paid dividends on their common stock for two consecutive years during the past fifteen years.

Form 10 Regarded as Basic

First let me discuss form 10, the form to be filed by corporations wishing to have the status of their securities now listed on the stock exchanges continued after July first of this year. Let me make clear at the outset that the mechanical regulations as to the manner of filing this form have not yet been promulgated. It seemed wise to the Commission not to defer the publication of this form until all these mechanical details could be thoroughly canvassed. So the form itself was promulgated in order that corporation executives and accountants could, before the end of the year, have an adequate conception of the nature of the information that would be required. Because of this fact—the absence of these mechanical requirements, it is impossible for me now definitely to answer certain questions that I find are asked commonly. Such questions, for example, as, what procedure will be required in the case of corporations whose fiscal year ended before December 31, 1934, and thus have already issued their statements in a different form than is now required? Or such a question, as to when deviations in substance from the Commission's requirements, as may be demanded by the very nature of the business, will be permitted? Or the question, as to what requirements the Commission will adopt with reference to quarterly statements or subsequent annual reports? These questions are still to be determined; but I can assure you that they will be determined shortly, in a sensible and practical manner.

Form 10 can be regarded as the basic form. The new form A-2 has been modeled upon it, deviating only where the need for providing different and additional information for new security issues has called for such change. The later forms will, in all likelihood, follow the same principle of basing themselves on form 10.

The problem raised by prescribing a form such as this is, of course, that of bringing to the investing public adequate information as to the nature and the record of securities now listed on the exchanges. The task was to accomplish this result and at the same time to make no demands either from the standpoint of difficulty, or of expense to which any corporation which

held itself out for public investment could reasonably object. Flexibility was, of course, essential. At the same time, definiteness was required so that corporations could understand clearly the obligations that they were asked to assume and could rely comfortably upon the requirements as phrased. I assure you that reaching the right balance between these considerations is no easy task. Though, of course, it is too much to hope that all these balances have been struck correctly, the help that we have had and the reception that our efforts have received so far, make me believe that, in the majority of instances, we have reached judgments that are fairly sound.

Outlines Data Sought by Commission

Form 10 may appropriately be considered as consisting of two parts. The one consists of financial data that the registering corporation is called upon to furnish; the other consists of information of a non-financial nature bearing upon the security being registered and absolutely essential to any determination of its investment merit. A brief glance at these non-financial questions, thirty-three in number, will illustrate the character of the material called for. First, a number of simple questions go to the organization of the registering corporation and of the system of which it may be an integral part. Next follow a series of questions which outline the capital structure of the corporation, calling for its authorized and outstanding funded debt; the debt structure of its subsidiaries; the authorized, issued, and outstanding capital stock of the registering corporation; the amount of securities of other corporations that it may have guaranteed; and its position with reference to outstanding warrants and rights. Then follow a series of questions directed towards getting an adequate description of the actual securities being registered, so that there should be a succinct statement of those matters relating to these securities of which any investor should be aware, such as conversion and redemption rights, interest or dividend rates, underlying collateral, substitution rights and the like. An effort to keep these descriptions brief and confined to elemental facts relating to the issue being registered has been made in these questions. To meet the desires of those investors who seek more detailed and thorough knowledge of such matters, the Commission, instead of calling for a more expanded description has, instead, merely requested the filing of certain exhibits, such as indentures or other constituent instruments defining the rights of the security holder. This is a desirable procedure, for it relieves the corporation of the difficult burden of summarizing the provisions of complex instruments, already presumably free from surplusage and unnecessary prolixity, but at the same time, it affords the inquisitive investor such evidence as will best inform him as to the nature of his rights.

There follows a question seeking information as to the recent financing that the corporation may have undertaken, which, from the investing standpoint, is one effective means of checking up on the recent general credit standing of the corporation. Finally, a series of questions relate to the control and management of the corporation. Large stockholding interests are

asked to be stated. The general cost of executive management is required, and, in order to bring the light of publicity to bear upon the larger salaries, those payable to directors and to the three highest executives are specifically required to be stated. At the same time, however, a decent respect for the confidential character of salaries is preserved by asking by name only for those which may be presumed generally to be above any question as to the need for non-disclosure from the purely managerial standpoint. Material management, engineering and supervisory contracts, which have been so unfortunately abused in recent years in some enterprises are also required to be disclosed.

Finally, one question directs itself towards such stock options as may be outstanding and thus may materially affect the trading position of these securities on an exchange.

The questions contained in the form are supplemented by instructions, which seek to define the nature of the questions with the hope thereby of getting more exactitude in the answers. Throughout, the instructions insist upon brevity in the answers, and by such devices as cross-referencing and permitting certain portions of the exhibits to be incorporated by reference, make brevity easy of achievement. We, as well as the investor, are weary of the voluminous answers that we have too often received. Neither fear of liability nor adequate investment description of the security demands this bulk and essentially confusing prolixity. We are now opening a means for brief, simple, inexpensive descriptions and we shall use our powers to their full extent to the end of securing that ready intelligibility that the wide investing public rightly demands.

I turn now to the second portion of the form, that portion which calls for financial data. Here, as distinguished from the forms earlier promulgated, flexibility is the rule. Let me illustrate this specifically. We require the latest balance sheet and the latest profit and loss statement, but though we set forth general instructions as to the substance of this data, we specifically permit the furnishing of these financial statements in any form that will be comprehensive and adequate. We set forth certain accounting terminology and accounting classifications, but we permit the use of other generally accepted terms and classifications. We call for consolidated balance sheets and consolidated profit and loss statements, but we do not insist that all subsidiaries shall be consolidated; instead we ask for the adoption of such a principle of inclusion and exclusion as will, in the opinion of the officers of the corporation, best exhibit the financial condition of the registrant, and in lieu of complete consolidation, the submission of separate financial statements as to those subsidiaries that the registrant has chosen to exclude. We do not prescribe the form of the accountant's certificate; instead we ask for a certificate that shall be illuminating both as to the scope of the audit and the quality of the accounting principles employed by the registrant. Or again, in dealing with such a problem as the annual charges for maintenance and repairs, and depreciation and amortization, we do not disturb the integrity of such an item as the cost of goods sold, where these charges, under

the accounting procedures practiced by a particular registrant, may be embraced within such an item. These, and other examples, are illustrative of the principle of flexibility employed in this portion of the form.

No Demand for Balance Sheets, Profit and Loss Data for Past Years

The general requirement is for financial statements covering the fiscal year ending last December or any date subsequent thereto which may be the closing period of a registrant's fiscal year. Why, it may be asked, do we not go beyond this and demand either balance sheets or profit and loss statements for several years back, especially in view of the fact that our supporting schedules with reference to such accounts as the property account and the investment account permit the accountant to take as his opening balance the closing balance of the prior fiscal year? To this there are several answers. In the first place, it must be remembered always that we are dealing with companies whose securities are already listed on the exchanges, and who consequently already have met the listing requirements of the exchanges and have, in accordance with these requirements, been reporting more or less adequately to the exchanges and to their stockholders during the past years. Furthermore, for the same reason, the bulk of the securities for which this form is available, are themselves seasoned in the sense that they have been before the public for many years and have recently passed through a period which generally has tried them so as to make apparent these historical and congenital weaknesses. In the second place, the emphasis from the investment standpoint, as distinguished, for example, from the standpoint of rate regulation, is placed by the requirements primarily upon present earnings rather than past history. Thus actual earnings as such, and current position, as such, are stressed as contra-distinguished from the ratio of earnings to actual investment. In the third place, without requiring comprehensive financial reports for past years, recognition is given to the fact that past accounting practices may affect the integrity of present reported earnings.

With this in mind, the regulations require a survey of certain outstanding practices which may have occurred during the past decade and which, in all probability, are still reflected in present reported earnings. Thus, substantial revaluations that may have been made in such specific accounts as investments in affiliates, the property account, and the intangible asset account, are required to be stated together with the contra-entries that will indicate the disposition of the amount added or deducted from the assets by such write-ups or write-downs. Again, any amount that may have been released from the capital stock account either by the device of paid-in surplus or by restatement of capital stock is to be fully accounted for; and, also, a specific finger is put upon the too frequent and pernicious practice of writing off debt discount and expense against arbitrary credits, rather than amortizing it over the period of the debt to which it relates, a practice which patently distorts the earnings statement and whose significance too often escapes even the vigilant investor. By this method, which avoids at the same time

the difficult task of actually auditing surplus over this period, the great weaknesses which may exist in that account are disclosed.

Now, let me turn for a moment to the general balance sheet and profit and loss requirements. Examination of the various items will disclose in no instance, I believe, any case where there is demand for figures that the great majority of corporations do not already possess, although they may not have made them generally available to their stockholders. To discuss these individual items at length is beyond the present scope of this talk, but a few general features deserve some comment. The first may be summed up in the phrase that current assets shall be truly current. No longer is it permissible to include among marketable securities, securities which do not truly meet that generally accepted criterion, and, at whatever figure these may be carried in the balance sheet, their value on the basis of current market quotations must also be shown. Furthermore, a breakdown of this item is required when, as in a few corporations, it represents a substantial portion of the total assets of the company. Again, current assets, if they consist of amounts due from subsidiaries or affiliates, are to be shown as such, and, in any event, are not to be treated as current assets unless the net current position of the subsidiary or affiliate justifies this treatment.

Requires Gross Sales and Cost of Goods Sold

A second feature of the financial statements is the insistence in the profit and loss statement upon gross sales and cost of goods sold. The importance of these figures to the investor are self-evident. Indeed, no other figures in the financial statements can, with the exception of net income, rank in equal importance with them. Obviously, the Commission is justified in calling for them. At the same time, it is to be recognized that in unusual circumstances, non-disclosure of these items may, perhaps, be justified, due to the extraordinary competitive nature of the enterprise in which the corporation may be engaged. Fortunately, from the standpoint of the investor, hesitancy on the part of corporations to the disclosure of these and other matters, is not general. A recognition that the corporation, as a trustee of other peoples' money, owes a general duty of disclosure to its beneficiaries is not something that the Commission need exercise the power of government generally to enforce. Indeed, my observation and my contacts lead me to the conclusion that this is a doctrine whose acceptance is more general than otherwise, and whose further acceptance needs only the encouragement and protection of government rather than the exercise of its power.

A word as to the matter of confidential treatment of material that may be required to be furnished. In promulgating general requirements, it is inevitable that some individualization of treatment must find its place in the administration of these requirements. The Act itself recognizes this by providing means for confidential treatment of certain material whose disclosure in a particular instance may damage rather than benefit the investor. The mechanism provided gives the corporation not only the right to request such confidential treatment, but requires the Commission to give the pro-

testing corporation the benefit of a hearing. What one would hope as a matter of administration will take place is that such requests will not be made without an accompanying informal but adequate presentation of the reasons that underlie such a request, and that the hearing will be demanded only in the very significant cases.

Many questions have been asked of us as to the relationship of these reports and the annual report made by the corporation to its stockholders. To put the general question more concretely, must the annual stockholders' report, for any reason, be identical with such reports as may be required to be filed with the exchanges and with the Commission? To answer this question, let me first analyze it. Form 10 is the form which is to be filed as of the time that permanent registration is sought. It need only be filed once. But the Commission is required by the Act to call for annual reports which in general, shall keep current the information filed in response to form 10. The Commission may also, in its discretion, call for quarterly reports. But the Commission possesses these powers only with reference to the reports furnished to itself and to the exchanges; it possesses no express power as to the content or nature of the reports sent to stockholders. It is agreeable that there is one way that the Commission might, however, affect the content of the stockholders' reports. This is by requiring that these reports should be filed with it, thus attaching to these reports the general statutory liabilities created by the Act. This requirement has not, however, been imposed. Even if it were imposed, nothing would prevent reasonable and non-misleading condensation of the financial statements filed with the Commission. But with no such requirement in existence, the content and character of these reports from a legal standpoint is governed only by common law liabilities. As a practical matter, one knows that major differences between the reports filed with the Commission and those sent to stockholders will not occur; but again, as a practical matter, one hopes that a reasonable degree of condensation will take place. The analytical stockholder will always still have easily available the degree of elaboration that can be found in the reports filed with the Commission and the exchanges, reports that under the law are accessible at all reasonable times to any inquirer. [Ed.: On January 19, 1935, the Commission amended rule KC 1 so as to make clear that during the period of temporary registration, issuers of securities temporarily registered were not under an obligation to file with the Commission documentary material sent by these issuers to their stockholders and others.]

Let me now leave form 10 for the moment and turn to form A-2, the recently promulgated form under the Securities Act governing new security issues. The experience of the Federal Trade Commission and our Commission had led many months ago to the conclusion that revision of the early form, A-1, was demanded, however adequate its requirements may be to deal with the promotional venture—the corporation with no history. For the seasoned corporation its requirements, though occasionally illuminating, imposed burdens and difficulties incommensurate with the value of these facts to the investor. It is, of course, impossible to get every fact that may have

investment merit before a prospective purchaser, and, however close one may come to such a goal in an individual case, to do it in a generalized fashion—the way in which law of necessity must operate—is much more difficult. For example, the answer to one question may be of vital importance in the hundredth case, but have no significance in the other ninety-nine cases where, nevertheless, the task of getting together the information involves both difficulty and expense. Thus, again, one is faced with a problem of basing generalizations upon nice and experienced judgments.

Companies with Listed Securities Favored

Form A-2, as I said before, is modeled after form 10. This very fact gives the corporation whose securities are listed, under the Exchange Act, a great advantage over the unlisted corporations, and rightly so, for the corporation that in the past has been dealing openly with its bondholders and stockholders should by that very fact be entitled to seek in the same open fashion new bondholders and new stockholders. This synchronization of these two forms means, in substance, that the task of the listed corporation in filing a registration statement under the Securities Act is, in essence, simple. The task of the unlisted corporation, contrariwise, is proportionately more difficult as its practices vary from the listing requirements prescribed under the Securities Exchange Act.

I can illustrate this thesis best by briefly comparing the two forms. In the non-financial data to be furnished, these are the chief additional features required to be stated:

1. A succinct statement of the franchise position of the registering corporation — obviously, in those businesses where franchises are the legal foundation of their privilege to operate or of the monoply they enjoy, a vital investment fact.

2. A description of the nature of those securities which rank either prior to or upon an equality with the security being offered.

3. A more detailed description of the security being offered, requiring besides such matters called for under form 10, additional data such as, for example, a brief description of which obligations rest upon the trustee in the event of default and what rights accrue to the bondholder upon the occurrence of the same contingency.

4. An analysis of the underwriting of the issue being offered including a definite disclosure of the underwriting spread or commission, as well as a disclosure of all preferred lists.

5. A statement with a reasonable degree of itemization as to the use to which the corporation is planning to apply the proceeds to be derived from the issue.

6. A statement as to the business experience of the corporation's chief executive officers, and of their major transactions with the corporation during the past few years.

7. A statement concerning pending litigation which may substantially threaten the financial position of the registrant.

8. Statements, carefully exact and limited, as to unexecuted and recent material contracts and as to material patents. A word as to these requirements, because from the standpoint of difficulty and expense to the corporation, the changes from the old form are of great consequence. As distinguished from the earlier requirement which called simply for material contracts not in the ordinary course of business, the new requirement delimits by definite and exact standards those contracts which, for the purposes of registration, are deemed to be material and are deemed not to have been made in the ordinary course of business. Similarly, the treatment of material patents is such that those patents only need be mentioned which, from an investment standpoint, are of particular significance, because the proceeds of the issue are to be used for their development. Furthermore, they are to be described in a general and not a highly technical manner so that the relationship of these patent rights to the security being offered shall be succinctly set forth.

Another Way in Which A-2 Differs with Form 10

These are the prime differences in that portion of A-2 that does not comprehend the financial data. The other portion of A-2, that concerns itself with financial statements, differs primarily from form 10 in only one respect, and that is the requirement for profit and loss statements covering three years rather than one. Of the absolute necessity for this requirement there can be no doubt, for to purchasers of new securities an earnings record over a period of years is, of course, essential. This change naturally brings some minor changes with it, such as slight adjustments in the supporting schedules, which will incorporate in these schedules such facts as the three year audit readily brings out. Similarly, a disclosure of the dividend record is required in the three year surplus analysis; and other like matters in appropriate schedules supporting items in the financial statements. With regard to the historical financial information, for the reasons that I advanced earlier, the requirements are the same; that is, a survey precisely directed to certain specified accounts and certain specified practices, going back, however, to 1922 rather than merely to 1925, but avoiding as form 10 does, by their very preciseness, the necessity for actual auditing over these past years and at the same time bringing about the disclosure of those practices whose effect upon income is still present.

Form A-2 is, I believe, a distinct advance over the early form A-1. Not only does it very materially lighten the difficulties and expense that were entailed by meeting the earlier requirements, but it also furnishes the investor with a sequence of more valuable and more current information. This, I feel sure, is bound to result both in a more informative and less cumbersome prospectus, and very much less hesitancy on the part of business executives and accountants in accepting the obligations of the Securities Act.

The work of getting out these two forms has been in preparation for many months. Indeed, some portion of that work even antedated the Securities and Exchange Commission; but these efforts, from our standpoint, will have, I believe, broken the back of the general problem though not, I trust, of our loyal staff and our hard-working accounting friends. Other forms to meet the special situations still unprovided for, are already on the way and will be launched shortly.

In this final effort, I feel sure that we can count upon your continued earnest cooperation, so that you will feel then as you should rightly feel now, participants in this truly democratic and joint process of government. You will still be more than welcomed at Washington for both your help, your criticisms and your inquiries.

I say, advisedly, "more than welcomed." For here, in order to don the role of a true government executive, I must make my own little threat, which is that you must, for your own good, come when we need you. Indeed, we need you as you need us — we to make government rightly respond to the desires of those who have the will, the ability and the experience to help us in attaining the objectives of candor, honesty and integrity in corporate finance, objectives that are common to all of us. Correlatively you need us to help you buttress with our strength your constant efforts in the same direction for more adequate and informative corporate accounting, efforts which have already and assuredly will continue to make your profession capable of fulfilling the high position of trust that our modern corporate civilization demands that it assume.

Presented at a meeting of the New York State Society of Certified Public Accountants held at the Waldorf-Astoria on January 14, 1935.

Questions Answered by Dr. Landis

Question: While all information is available to the Commission, where can the investing public secure this information? How is the investing public to be notified where it can secure any and all necessary data which the Commission is gathering?

Answer: The records of the Commission, as a whole, are public records. Of course, they are available down in Washington. More than that, they can be made available to any one at any place, for a nominal fee. Moreover, the information filed with the Commission is filed at the various exchanges, and the exchanges unquestionably will accord with our desires and make that information reasonably accessible to the investing public. The newspapers themselves keep the investing public well advised. As to the information that is filed with the Commission, if this and that corporation files a report, it is immediately known; the papers carry it though it may be only a summary. Indeed, some of the papers have been very active in portraying a great deal of the information that is down at the Commission.

Question: What is meant by the statement that there should be disclosed information on repairs, maintenance, etc., but that it is not necessary to disturb the integrity of the cost of sales accounting?

Answer: As you know, some corporations carry those items separately. Some corporations absorb those items in the item, "cost of goods sold." We do not require that that item must be segregated from the item, "cost of goods sold." What we do ask for is a general disclosure as to what charges are made for repairs and maintenance, without requiring that they be completely segregated and

broken down in the profit and loss statement, unless the accounts are actually kept so as to show such segregation. The information is essentially of a memorandum nature.

QUESTION: Under item 27, is it necessary to report fees of $20,000 or more paid to lawyers, accountants or auditors, and advertising agencies?

ANSWER: The reply to that is generally yes.

QUESTION: Will Dr. Landis explain the reason for placing depreciation as item four on the profit and loss statement and if it is compulsory for the company reporting to show it in that position?

ANSWER: The registrant may file statements and schedules in such form, order and using such generally accepted terminology, as will best indicate their significance and character in the light of the instructions.

QUESTION: A company has authorized issue of 1,000 shares of $100 par, totaling $100,000, of which 500 shares were issued in 1930 for $50,000. The company desires an additional $50,000. Can the remaining 500 shares be sold privately to a group of ten to fifteen private individuals without the necessity of registering them?

ANSWER: Our regulation governing issues under $100,000, provides that in that particular situation the issue can be sold to the public without registration — and therefore, *a fortiori,* there would be a right to offer them privately.

QUESTION: What is the Securities and Exchange Commission's attitude towards valuations resulting from physical appraisals? What should be their limitations in so far as cost is concerned? Should the cost be stated as an insert where appraised values are used?

ANSWER: The Commission requires disclosure of revaluations made since January 1, 1925, under the Exchange Act and since January 1, 1922, under the Securities Act. As far as current practice goes, variations from cost must be shown in the supporting schedule to the asset accounts.

QUESTION: What is the Commission's attitude toward private sales of securities now that the complete regulations concerning issuance of securities have been published?

ANSWER: That, gentlemen, is a serious question. I imagine that not only the Commission but many others look with regret upon this type of offering. From the standpoint of the protection of the buyer, no one need ordinarily be alarmed; but from the standpoint of the opportunity that may be afforded to the investing public as a whole, one observes with regret resort to that type of offering. You note that the other day another department of government indicated its opinion toward that type of offering, saying in its regulations that banks under its jurisdiction should not accept offerings of that type unless two things were true: One, that there was a wide public distribution of other securities of the same issues, and—not "or"— that the particular securities being so offered should be registered under the Securities Act of 1933.

Many questions ask for a legal opinion, which I would hesitate to render in this offhand manner, and I also hesitate to render what might be called account-

ing opinions. Let me rather deal with questions calling for general observations. I don't want to lead you to any wrong conclusions, and I am afraid that if I dealt with questions of a different nature I might make a slip wholly unintentionally that somebody would take too seriously. Here, for example, is a question on statutory consolidation, as to whether statutory consolidation does or does not come within the exemption of the Securities Act.

I should suggest that you write our general counsel on that matter. We argued that case for three weeks. We came to a conclusion, though, that issues by way of statutory consolidation were not within the terms of the act.

QUESTION: Are any reports required of corporations not listed on an exchange, but enjoying non-listed privileges on an exchange, such as the New York Curb Exchange?

ANSWER: Under the regulations originally imposed, no such reports were required to be filed by the issuers, and in fact, those issuers were specifically exempted, as they had to be, because their securities were introduced upon an exchange without their approval. Hence they had to be exempted from certain obligations which you could put upon a fully listed security.

QUESTION: Are we to understand that the Commission does not intend to prescribe specific forms for annual reports to be distributed to stockholders of listed corporations? If so, how about section 13 of the Securities Exchange Act of 1934?

ANSWER: Let me repeat, this question carries the confusion of thought that has reigned in this field. Namely, there are two types of reports, reports made to the Commission and to the exchanges, and the type of annual report to be sent to stockholders. Section 13 deals with the first type of report, and not the second type of report. To answer the earlier part of the question—what is the Commission's intention with reference to specific forms for annual reports—it depends on what annual reports you are talking about. If you are talking about the annual reports to be filed with the Commission and the exchanges, obviously the Commission intends to promulgate regulations governing those annual reports; if it did not do so it would not be carrying out the mandate of section 13. But when you are dealing with the problem of the annual reports to stockholders, no present need, certainly, for any regulations dealing with that problem seems apparent.

QUESTION: How much weight does the Commission attach to the depreciation provisions made by a company for tax purposes in judging the adequacy of the depreciation provisions taken on the books and shown in the annual report?

ANSWER: Forms 10 and A-2, as distinguished from the earlier forms do not call for the figures on depreciation, contained in the registrant's tax returns. It is not our purpose, neither is it our function, to judge the adequacy of a depreciation provision; it is only our function and only our purpose to bring out the facts with reference to it. This fact has not been required by the recent regulations. I think I do not need, before this audience, to go into a discussion as to the difference in calculating depreciation for tax purposes and for financial and management purposes, especially in the light of the new regulations that have been imposed by the Internal Revenue Bureau. We are dealing with investment, not

taxation; and from the investment standpoint, the figures that you want are depreciation calculated from the financial and managerial standpoint. We ask questions as to the registrant's policy as to its depreciation charges, but we do not call for information as to its tax returns.

QUESTION: Do you think that if the Treasury Department, after investigation, establishes a figure for depreciation to be deducted for tax purposes, it should be considered sufficient confirmation of the adequacy of the depreciation deducted in the financial accounts?

ANSWER: That, of course, is a question distinctly for the accountant.

QUESTION: What is his responsibility in that nature?

ANSWER: That is a question upon which I am not competent to give any answer because it relates distinctly to the accountant's obligations to his own profession.

QUESTION: Will utility companies be expected to classify their assets and liabilities as to current, long-term, etc., where they have not in the past been in the habit of so doing, and where such information on such a company is not particularly important?

ANSWER: There, again, you are dealing with the general standard that is set forth in our requirements as to financial data. What we say is follow them unless you adopt another method that shall be just as informative. Certainly, it is informative to segregate current from non-current assets. What we should seek for is that information. Now if it is unimportant in the particular case, then, of course, you have a deviation there of a non-material character, but unless that deviation is purely non-material in character, you would call for the type of segregation that the form itself asks for.

QUESTION: Is it your opinion that the reader of a company's accounts, reported upon by an independent certified public accountant under the regulations of the Securities and Exchange Commission, is entitled to assume they are correct without reservation, or do you think it would be more proper for the reader to assume that the accountant merely has expressed his opinion based upon his examination and best judgment that the company's balance sheet position and results of operations are fairly presented as a going concern?

ANSWER: That, of course, goes to the heart of the nature of an accountant's duty and the character of his work. It is obviously wrong to assume that the mere fact that an independent certified public accountant has undertaken to affix his signature under certain regulations to a document required to be filed with the Commission is, in itself, a guarantee as to its accuracy. Nothing that we can do will ever supplant the guarantee that can only come from the reputation of the accountant himself. In financial statements you are getting a combination of human judgment on certain questions and a survey of some things that are matters of fact. What you want to know is the character of what the accountant has done and the basis upon which he has formed his judgments. That, of course, is the very heart of the accountant's certificate. We have not prescribed the form of that certificate; rather, we have put responsibility back upon the accountant himself. We have put that responsibility where it belongs, so that by the character

of the accountant's certificate itself, plus, of course, his general reputation, the value of his work can be best determined.

QUESTION: Many companies are under agreement with the New York Stock Exchange to publish annual reports to stockholders in the form shown in the last listing application. Should they continue to do so this year?

ANSWER: That, of course, is a problem which the Exchange will have to work out. The difficulties of working out the relationship of that agreement to our requirements should not be material. As a general matter of fact, no major departures from the general listing requirements or the general registration statements that will be filed with us, would be undertaken by corporations as a whole. They would have no reason to make such major departures. The problem thus becomes simply one of condensation, and that problem is not a difficult one to solve.

QUESTION: What is the accountant's liability in certifying the financial data supplied in form 10? Is it as onerous as in the filing of form A-2?

ANSWER: The technical language of the Acts are different. The accountant's liability on form 10 is set forth in section 18 of the Exchange Act, and, where a false or misleading statement is made, places upon the accountant the necessity of establishing that he acted in good faith and had no knowledge that the statement was false or misleading. The liability of the accountant in reference to form A-2 is set forth in section 11 of the Securities Act of 1933 and is somewhat broader. It has been discussed many times. In substance it places upon an accountant the necessity of establishing that he exercised due care, as well as good faith and lack of knowledge of the false or misleading character of a statement. That, I think, is the primary difference at the present time. Another difference that exists between those two liabilities, is the lack of the reliance requirement in the Securities Act and the presence of the reliance requirement in the Exchange Act. The other difference, which is primarily, I believe, a difference in the language which sets forth that liability, is not a material one.

QUESTION: Is it possible to consult with the Commission or its authorized representatives as to principles of presentation of accounts and the admissibility of various practices previous to the closing of a corporation's books or rendering of statements or reports to the Commission or to stockholders? If this is the case, what is the procedure in arranging such a conference?

ANSWER: The procedure in arranging such a conference is simply to call up the chief of our registration division, or whomever you may be put into contact with there. There is no difficulty at any time in arranging conferences of that nature. We have scheduled, I know, several conferences preparatory to the preparation of listing applications. We have adopted consequently the practice of holding conferences prior to the actual filing of a registration statement, so that mistakes will not be made subsequently, but will be prevented rather than first made and then corrected.

The Administration of the C. P. A. Law in New York State

By HARLAN H. HORNER

CHAPTER 312 of the laws of 1896, which became a law on April 17 in that year, was the original act in New York State "to regulate the profession of public accountants." This was the first accountancy law in the United States. The law was brief and, therefore, may be given in full as follows:

> SECTION 1. Any citizen of the United States, or person who has duly declared his intention of becoming such citizen, residing or having a place for the regular transaction of business in the state, being over the age of twenty-one years and of good moral character, and who shall have received from the regents of the university a certificate of his qualifications to practice as a public expert accountant as hereinafter provided, shall be styled and known as a certified public accountant; and no other person shall assume such title, or use the abbreviation C.P.A. or any other words, letters or figures, to indicate that the person using the same is such certified public accountant.
>
> SECTION 2. The regents of the university shall make rules for the examination of persons applying for certificates under this act, and may appoint a board of three examiners for the purpose, which board shall, after the year eighteen hundred and ninety seven, be composed of certified public accountants. The regents shall charge for examination and certificate such fee as may be necessary to meet the actual expenses of such examinations, and they shall report, annually, their receipts and expenses under the provisions of this act to the state comptroller, and pay the balance of receipts over expenditures to the state treasurer. The regents may revoke any such certificate for sufficient cause after written notice to the holder thereof and a hearing thereon.
>
> SECTION 3. The regents may, in their discretion, waive the examination of any person possessing the qualifications mentioned in section one who shall have been, for more than one year before the passage of this act, practicing in this state on his own account, as a public accountant, and who shall apply in writing for such certificate within one year after the passage of this act.
>
> SECTION 4. Any violation of this act shall be a misdemeanor.
>
> SECTION 5. This act shall take effect immediately.

The original act was amended by chapter 25 of the laws of 1909 when, under the consolidated laws of New York, the provision for the regulation of the practice of public accountants was set up as article VIII in the general business law under the title of "public accountants." No material amendment was made at this time. Chapter 443 of the laws of 1913 provided for the endorsement of a license or certificate earned in another state.

In a general act to amend the education law to conform to the state department's law in relation to the practice of several professions, including public accounting, what had been article VIII of the general business law became, through chapter 85 of the laws of 1927, article 57 of the education

law in relation to "public accountants." This revision made no material change in the statute.

Important Changes in Accountancy Law

Chapter 261 of the laws of 1929 repealed in toto article 57 of the Education Law in relation to "public accountants" and substituted therefor a new article 57 in relation to "certified public accountants." This act embodied a thorough-going revision and enlargement of the statute and set up the accountancy law in substantially the form which still prevails. The material changes in the statute in 1929 may be briefly recorded as follows:

1. The Board of Certified Public Accountant Examiners was enlarged from three to "at least five members" and detailed provision was made for the qualifications and expenses of the members, for the organization and meetings of the board, for receipts and disbursements and for records.

2. The regents were authorized to appoint a "council on accountancy" to "advise with the department, the board, and any other public officers concerning any and all matters" within the purview of the statute.

3. Penalties and their collection were set up for violation of the statute and provision was made for the revocation or suspension of certificates for cause.

4. The regents were required to appoint a "committee on grievances" of ten members and the functions, jurisdiction and procedure of the committee were outlined clearly.

5. Provision was made for the registration of copartnerships.

6. A more standardized system was provided for endorsement of certificates from other states, with greater discretionary power in the Department and the Board of Examiners.

7. Perhaps the most significant and far-reaching amendment or addition in the revised statute dealt with the future educational requirement for the C.P.A. certificate in section 1498-a of the law which provides that every candidate for examination for a certificate as a certified public acountant after January 1, 1938 must be a graduate of an approved course of study in a school or college of accountancy.

Subsequent amendments to the statute, chapter 337 of the laws of 1930 and chapter 425 of the laws of 1932, have been incidental and related to the appointment of the committee on grievances and to proceedings before the committee.

Requirements for the C.P.A. Certificate

Pursuant to the provisions of chapter 312 of the laws of 1896, the regents enacted the following rules for public accountants' examinations and certificates on October 15, 1896:

Regents Rules for Public Accountants' Examinations and Certificates

1. The use of the abbreviation C.P.A. or any other words, letters or figures to indicate that the person is a certified public accountant is prohibited except to those holding regents certificates.

2. The three examiners are to be appointed to serve for one, two and three years respectively.

3. Certificates shall be revoked for cause.

4. Examinations may be waived on unanimous recommendation of the examiners in the case of candidates well known to them as meeting the professional requirements and as having been in reputable practice as public accountants since January 1, 1890, the same fee to be paid as for examination.

5. The full C.P.A. certificate is to be granted only to those at least twenty-five years of age who have had five years satisfactory experience in the study or practice of accounting.

6. Candidates having the required preliminary education and passing the required examinations but without the age or the five years experience required for the full C.P.A. certificate may be certified as junior accountants under the same conditions as to residence and character.

7. Two examinations, in June and December, are to be held annually. There are to be four sessions of three hours each as follows: 1—theory of accounts, 2—practical accounting, 3—auditing, 4—commercial law.

8. Candidates must complete all four subjects at a single examination as required in medicine.

9. Candidates for either the C.P.A. or the junior accountant certificate must be more than twenty-one years of age and of good moral character. They must pay a fee of $25 and must have the regents academic diploma or its equivalent, as prescribed for other professional examinations.

On June 26, 1899 the regents changed the rules to provide that a C.P.A. certificate could be granted to a person at least twenty-five years of age who had had three years satisfactory experience in the practice of public accounting of which at least one year must have been in the office of an expert public accountant.

On September 20, 1905 the regents codified their rules. Chapter 10 of the new rules entitled, "regents special rules relating to certified public accountants," read as follows:

1. Board of examiners. The regents of the university shall annually at their meeting at the time of the university convocation, from those holding their certificates as certified public accountants, appoint a board of three examiners, to serve for one year, to examine, under the regents rules, persons applying for certificates under the act (chapter 312 of the laws of 1896) to regulate the profession of public accountants.

2. Examinations. Two examinations of four sessions each shall be given annually, at which duly qualified applicants shall be examined in the following subjects during the times indicated: (1) theory of accounts, 3 hours; (2) practical accounting, 4 hours; (3) auditing, 3 hours; (4) commercial law, 3 hours. The specified four subjects must all be taken at the same semi-annual examination.

3. Places and times for examinations. Applicants will be duly informed of the places for examinations, which shall be held either in New York, Albany, Syracuse or Buffalo, and be given at times to be fixed by the Education Department.

4. Preliminary education required. Except as provided in rule 5, a certificate as a certified public accountant will be issued only to those who, in addition to meeting the specific requirements of the law, have approved professional qualifications and, as part thereof, hold the regents academic diploma or furnish satisfactory evidence of having an accepted equivalent preliminary education.

5. Examinations waived. In the discretion of the Board of Regents, examinations as to preliminary education may be waived, and in that particular applicants be deemed duly qualified for certificates, in cases of those whom the board of examiners shall unanimously certify to have possessed all required qualifications at the time of the passage of the act (chapter 312 of the laws of 1896) to regulate the profession of public accountants; and all examinations may be likewise waived in the cases of those whom the board of examiners shall unanimously certify to be well known to them as meeting the professional requirements and as having been in reputable practice as public accountants since January 1, 1890. Such applicants shall, however, pay the fee of $25 for their certificates.

6. Fee. The fee for an examination and certificate shall be $25 to be paid upon applying for admission to the professional examination. Such application should be made at least 10 days prior thereto at the Education Department at Albany, and be accompanied with evidence of due compliance with the other requirements of the law and of the regents rules. Suitable blanks and instructions will be furnished by the Department to intending applicants, upon their timely request.

Changes Regarding Examinations and Experience Requirements

On March 12, 1908, rule two of the above mentioned chapter 10 was amended by dividing the examination in practical accounting into two sessions and providing that a candidate failing in but one subject of the examination should be required to pass in a subsequent examination, only the one subject in which he had failed in order to obtain a certificate. It should be noticed that the experience requirement continued to be three years of satisfactory experience, one of which must have been in the office of an expert public accountant.

On November 20, 1913, the regents amended their rules to require five years of experience in the practice of accountancy, at least two of which should be in the employ of a certified public accountant in active practice in no less grade than that of a junior accountant. On April 30, 1914, the rules were amended again by adding a new rule covering endorsement of certificates from other states and reading as follows:

> A citizen of the United States, residing in or having a place for the regular transaction of business in this state, who has personally practiced for three years as a certified public accountant in another state under a license or certificate earned by passing the regular written certified public accountant examination in that state, may, upon evidence that such written examination of the other state was of not lower standard than that required of applicants in this state and upon recommendation of the Board of Certified Public Accountant Examiners, receive from the Board of Regents a certificate as a certified public accountant without examination, provided the state from which the applicant presents

a license shall have filed an agreement with the Board of Regents to endorse, in similar manner, licenses issued in this state and provided the applicant has the academic education specified in section 426 of the regents rules. The fee for the endorsement of the certificate shall be $25, the same as that for the issuance of a certificate in this state.

On July 1, 1916, the regents rules were amended to provide that, thereafter, the equivalent of the high school preliminary education requirement should be seventy-two counts in regents examinations in specified and elective subjects instead of sixty as theretofore.

On January 31, 1918, the experience requirement was amended again, to provide that the applicant might be admitted to the examination on the completion of three of the five years experience.

On October 19, 1922, the regents amended the rule covering endorsement of certificates from other states by striking out the following words: "Provided the state from which the applicant presents a license shall have filed an agreement with the Board of Regents to indorse in similar manner licenses issued in this state and."

On February 26, 1925, the rules were amended again to provide that two and one-half years experience in the United States Army during the world war could be accepted as equivalent to six months experience in the office of a certified public accountant.

Other Amendments on Education and Experience Requirements

On June 30, 1927, the rules were amended again to provide that:

1. Ten years experience in the practice of accountancy might be accepted in lieu of the required high school education provided evidence of such experience was filed prior to the C.P.A. examination scheduled to be held in November, 1929.

2. The two years of experience in the office of a C.P.A. could be completed in the office of a C.P.A. residing in another state provided he held from such state a certificate granted on requirements not less than our own.

3. A graduate from a college or school of accountancy and business administration could be given credit for two years of general experience in accountancy.

4. Ten years practice of public accountancy by an applicant on his own account could be accepted as meeting the experience requirement provided that such experience was diversified in character and that his application was filed on or before January 1, 1930.

5. Candidates failing in only one subject might take subsequent examinations in that subject within two years without additional fee; thereafter a fee of $5 was to be required for each examination.

On March 29, 1928, the regents repealed all of their previously enacted rules and reenacted new rules providing for regulations of the commissioner of education to regulate admission to professional study and practice. There-

upon, the commissioner enacted regulations covering the C.P.A. requirements which were approved by the Board of Regents. In effect, these regulations reestablished much the same requirements as follows:

1. Preliminary education. Satisfactory completion of four years of high school study or the equivalent which might be ten years practice of public accountancy provided application was made prior to November 1, 1929.

2. Professional experience. The same five years experience of which three must be completed prior to admission to the examination and of which two must be completed in the office of a certified public accountant. As an equivalent, provision was made for the acceptance of ten years practice of public accountancy on the applicant's own account and in the state of New York provided such practice was diversified in character and application was filed with the Department not later than January 1, 1930. The credit for military service in the world war was continued as well as the two years experience credit for graduation from a registered college or school of accountancy and business administration.

3. Examination. The requirements covering reexamination on failure in not more than one subject of the examination were reestablished.

Attention is called to the fact that the old rule providing for the endorsement of certificates from other states was not reenacted.

On June 13, 1929, the regulations were amended advancing the time within which ten years practice of public accountancy might be accepted as the equivalent of the preliminary education requirement to January 1, 1938. At the same time a new equivalent of the professional experience requirement was added, namely, seven years experience in accountancy, at least four of which shall have been in the office of an accountant, qualified by ten years of approved experience, to apply for a C.P.A. certificate on examination in this state. In addition, the time within which the applicant could submit as equivalent to the experience requirement, ten years practice on his own account, was advanced to January 1, 1938 and the amount of credit allowed to a graduate of a college or a school of accountancy and business administration was increased from two years to three.

The new C.P.A. law enacted in 1929 provided that the Board of Examiners might make rules to be approved by the regents covering the duties assigned to them by the statute. These rules finally were made and were approved by the regents on January 16, 1932. They made no change in the requirements for the certificate, but stated definitely how the requirements should be administered. They were printed in the hand-book and constituted an additional aid to the applicant in his inquiry as to the requirements he must meet.

On March 15, 1934, the regulations were amended again with reference to the amount of experience credit to be given for graduation from a school of accountancy and business administration, the time for filing applications for admission to the examination and reexamination.

On May 17, 1934, the regulations were amended again by the addition of a definition of acceptable experience. These 1934 amendments are discussed in detail later in this study.

Certificates Issued

Since the enactment of the original statute on April 17, 1896 down to October 1, 1934, 4,722 certificates as a certified public accountant have been issued under the waiver provided in the first law, upon examination and by endorsement as follows:

Year	Number under waiver		Number on examination	Number by endorsement
1896-97	104		8	—
1897-98	12		5	—
1898-99	2		10	—
1899-00	2		9	—
1900-01	12		13	—
1901-02	37		47	—
1902-03	1		10	—
1903-04	3		22	—
1904-05	3	(regents action	36	—
1905-06	—	ch. 343, Laws	17	—
1906-07	—	1901)	36	—
1907-08	—		17	—
1908-09	—		21	—
1909-10	—		19	—
1910-11	—		37	—
1911-12	—		38	—
1912-13	—		36	—
1913-14	7		28	—
1914-15	—		29	—
1915-16	—		45	—
1916-17	—		48	—
1917-18	—		41	—
1918-19	—		54	1
1919-20	—		58	1
1920-21	—		102	0
1921-22	—		159	0
1922-23	—		162	2
1923-24	—		149	8
1924-25	—		194	15
1925-26	—		293	4
1926-27	—		252	14
1927-28	—		285	11
1928-29	—		200	25
1929-30	—		258	6
1930-31	—		303	169
1931-32	—		396	85
1932-33	—		290	40
1933-34	—		242	45
July 1 to Oct. 1, 1934	—		139	5
Total	183		4,108	431

Results of C.P.A. Examinations, 1896-1934

Years	Examinations Taken	No. Rejected	Per cent Rejected
1896-97	14	6	42.9
1897-98	15	9	60.0
1898-99	17	7	41.2
1899-00	16	7	43.8
1900-01	17	4	23.5
1901-02	129	82	63.6
1902-03	68	58	85.3
1903-04	82	60	73.2
1904-05	77	41	53.1
1905-06	78	61	78.2
1906-07	104	74	71.2
1907-08	122	99	81.1
1908-09	112	64	57.1
1909-10	135	82	60.7
1910-11	150	89	59.3
1911-12	204	169	82.8
1912-13	220	190	86.4
1913-14	250	207	82.8
1914-15	293	266	90.8
1915-16	324	205	63.3
1916-17	276	337	89.6
1917-18	241	175	72.6
1918-19	229	179	78.2
1919-20	293	193	65.9
1920-21	327	196	59.9
1921-22	534	267	50.0
1922-23	700	542	77.4
1923-24	1,105	833	75.4
1924-25	1,189	901	75.8
1925-26	1,131	961	85.0
1926-27	1,495	1,267	84.7
1927-28	1,658	1,373	82.8
1928-29	1,982	1,834	92.5
1929-30	2,306	2,047	88.8
1930-31	2,425	2,096	86.4
1931-32	2,402	2,156	89.8
1932-33	2,135	1,963	91.9
1933-34	2,103	1,780	84.6
Total	24,958	20,880	83.2

The detailed results of the October, 1933, and the April, 1934, examinations appear as follows:

	October, 1933		April, 1934	
	No.	Per cent	No.	Per cent
Candidates taking 4 subjects	677		636	
Passed 4 subjects	35	5.2	22	3.4
Passed 3 subjects	103	15.2	94	14.8
Passed 2 subjects	65	9.6	185	29.1
Passed 1 subject	126	18.6	126	19.8
Failed in 4 subjects	348	51.4	209	32.9

	October, 1933		April, 1934	
	No.	Per cent	No.	Per cent
Candidates taking 3 subjects			3	
Passed 3 subjects			1	
Passed 2 subjects			0	
Passed 1 subject			1	
Failed in 3 subjects			1	
Candidates taking 2 subjects			94	
Passed 2 subjects			12	12.8
Passed 1 subject			53	56.4
Failed in 2 subjects			29	30.8
Candidates taking 1 subject	332		361	
Passed	106	32.0	147	40.7
Failed	226	68.0	214	59.3
Total candidates	1,009		1,094	
Passed	141	14.0	182	16.6
Failed	868	86.0	912	83.4

While this record seems very bad indeed, it is to be kept in mind that the total number of different persons taking examinations during the last thirty-eight years is not one-third of the number of appearances in the examinations because many candidates have taken the examinations repeatedly. The 24,958 appearances in the examinations have been made by 7,590 candidates. Out of the 7,590 different persons who have sought the C.P.A. certificate through examination 4,274, or 56.3 per cent, have received the certificate.

Compares Results of Institute's Examinations

The percentage of mortality in these examinations throughout the time they have been conducted in this state remains high even with this explanation. Inquiry reveals that the situation is not peculiar to New York. A like condition exists throughout the country. The American Institute of Accountants and the American Society of Certified Public Accountants, professional organizations, have Boards of Examiners which set examinations for the C.P.A. certificate in some states. The Institute prepares all the question papers and various state boards employ the papers for their examinations while the American Society performs a similar service for eight states. In some cases the state boards rate the answers but mainly the papers are rated by the Institute's examiners. Last year thirty-five states and territories employed the Institute's examinations. It is interesting to note that there were about 1,400 candidates from these thirty-five jurisdictions. Some idea of the magnitude of our problem in New York State may be had when it is recalled that 1,094 candidates sat in our April, 1934, examination. The results of the Institute's central examining of papers set by it since 1917 are as follows:

	Passed	Conditioned	Failed
1917-18	62	39	13
1918-19	185	93	129
1919-20	365	337	417
1920-21	246	345	823
1921-22	353	275	648
1922-23	246	236	530
1923-24	306	250	407
1924-25	226	179	533
1925-26	154	225	562
1926-27	265	240	440
1927-28	212	176	603
1928-29	152	124	745
1929-30	110	119	814
1930-31	118	165	789
1931-32	169	136	712
1932-33	164	169	547

About four states, in addition to New York, conduct their own C.P.A. examinations independently. Space does not permit the inclusion of the examination statistics from these states but the results show the same trend as our own examinations and those of the Institute.

Reasons for High Percentage of Mortality in Examinations

What are the basic reasons for this uniformly high percentage of mortality in examinations for the C.P.A. certificate in New York State and throughout the country? Let us undertake to state them in general terms as they have been advanced from various quarters and examine them in the light of our own experience in this state.

Unlike many other professions, accountancy has not developed a clear cut system of academic and professional courses of study required as a minimum preparation for all candidates for admission to an examination for the C.P.A. certificate. In medicine, for instance, a minimum requirement of academic and professional study prevails throughout the country. No student may be admitted to a standard medical school approved by the American Medical Association who has not had at least two years of work in a college of liberal arts or science including certain credits in English, biology, chemistry and physics. Beyond that no such student may receive the degree of M.D. who does not satisfactorily complete a four-year course in an approved medical school. While the medical course is not uniform in the medical schools throughout the country the major objectives of all the schools are similar and the scope and content of the subjects offered are understood universally. The same relative situation exists in dentistry. As a consequence, groups of students come up to the medical and dental licensing examinations annually knowing what to expect and do not meet with the disaster attendant upon C.P.A. examinations. The results of the licensing examinations in medicine and dentistry in New York for the last ten years of record will illustrate this point.

Results of Medical Licensing Examinations, 1923-1933

Year	Candidates	Number rejected	Per cent rejected
1923-24	900	183	20.3
1924-25	1,147	216	19.0
1925-26	1,038	173	16.6
1926-27	1,077	151	14.0
1927-28	1,067	153	14.3
1928-29	1,130	214	18.9
1929-30	1,047	196	19.0
1930-31	1,145	195	17.0
1931-32	970	245	25.2
1932-33	929	191	20.6

Results of Dental Licensing Examinations, 1923-1933

Year	Candidates	Number rejected	Per cent rejected
1923-24	783	218	27.8
1924-25	717	153	17.6
1925-26	425	118	27.7
1926-27	503	129	25.6
1927-28	492	100	20.3
1928-29	448	102	42.4
1929-30	350	76	21.7
1930-31	319	65	20.3
1931-32	336	49	14.0
1932-33	457	77	16.9

These figures for medicine and dentistry include the records of graduates of schools in other states and countries as well as from our own schools within the state. The percentage of our home graduates who pass is considerably higher.

On the other hand, the only conventional educational requirement yet set anywhere in the United States for a candidate for the C.P.A. certificate is high school graduation. No orderly professional training in a college or university is required anywhere. It is true that schools of business have made remarkable progress in our universities in recent years and that courses in accountancy have been introduced widely. There has been little progress, however, in reaching anything like agreement upon what professional training a future practitioner of public accountancy should have.

The apprenticeship system which has disappeared in medicine and dentistry entirely and which rapidly tends to disappear in law, architecture and engineering still widely prevails in accountancy. As a result candidates for the C.P.A. certificate come up for examination without basic uniform training, with the widest possible range of individual fitness, without having been able to center upon clear cut objectives in such training as they have endeavored to secure for themselves in offices or in the instruction they may have received in collegiate institutions. At the same time, boards of examiners are uncertain about what they prescribe and nowhere are able to test the results of uniformly systematic education. The candidates not only do not know where they are going, the examiners often do not know exactly where they wish to lead them. The whole process is an unfortunate groping

of both candidates and examiners in the dark. Light will not come until the meaning, scope and purpose of professional training and examining are understood universally and coordinated as they have been in medicine. Until that day arrives, we may expect a relatively high percentage of mortality in our C.P.A. examinations.

The state of New York leads the nation in pointing the way. After January 1, 1938, under the provisions of section 1498-a of the Education Law, as has been indicated;

> "Every candidate for examination for a certificate as a certified public accountant shall present evidence that he has satisfactorily completed the course of study in a college or school of accountancy registered by the Department as maintaining a satisfactory standard, and that prior to the beginning of his course of study in such college or school of accountancy he satisfactorily completed a four year high school course approved for this purpose or the equivalent as determined by the commissioner of education."

Looking forward to the enforcement of this provision of the statute the Department has formulated a course of study leading to a bachelor's degree in a four year course in a college or school of accountancy as a basis for registration. This course was determined upon after frequent conferences of Department officials with the Council on Accountancy, the Board of Certified Public Accountant Examiners and the deans of all the schools and colleges of business in the state. It was determined that the course should be devoted approximately one-half to liberal arts and science and one-half to professional studies in the field of accountancy and that the professional studies should include at least twenty-four hours in accounting, eight hours in commercial law, eight hours in finance, six hours in economics and fourteen hours in professional electives including business management and organization, statistics and insurance.

Widespread interest has been manifested in the approaching operation of our statute in this connection and applications for the registration of courses of study in accordance therewith have been received from practically all the leading schools and colleges of business, offering major work in accountancy, throughout the United States. Courses for this purpose have been registered within the year as follows:

Registered Courses in Accountancy

Alabama

University of Alabama, School of Commerce and Business Administration (four-year course, B.S. in Com. & B.Ad.).
University; dean, Lee Bidgood.

California

University of California, College of Commerce (four-year course, B.S.).
Berkeley; dean, Henry Francis Grady.
University of Southern California, College of Commerce and Business Administration, (four-year course, B.S. in B.A.).
Los Angeles; dean, Reid L. McClung.

Georgia

Emory University, School of Business Administration (four-year course, B.B.A.).
Atlanta; dean, Edgar H. Johnson.

Illinois

Northwestern University, School of Commerce (four-year course, B.S. in Com.—accounting major).
Evanston and Chicago; dean, Ralph E. Heilman.

University of Illinois, College of Commerce and Business Administration (four-year course, B.S.—curriculum in accounting).
Urbana; dean, Charles M. Thompson.

Indiana

University of Notre Dame (four-year course, B.C.S.—program in accounting).
Notre Dame; dean, J. E. McCarthy.

Iowa

State University of Iowa, College of Commerce (four-year course, B.S. in Com.).
Iowa City; dean, Chester A. Philips.

Kansas

University of Kansas, School of Business (four-year course, B.S. in B.A.—accounting curriculum).
Lawrence; dean, Frank T. Stockton.

Kentucky

University of Kentucky, College of Commerce (four-year course, B.S. in commerce—accounting course).
Lexington; dean, Edward Wiest.

Massachusetts

Boston University, College of Business Administration (four-year course, B.S. in B.A.—accounting major).
Boston; dean, Everett W. Lord.

Harvard University, Graduate School of Business Administration (two-year course, M.B.A.; three-year course, D.C.S.).
Boston; dean, Wallace Brett Donham.

Michigan

University of Detroit, College of Commerce and Finance (four-year course, B.S. in accounting).
Detroit; dean, Carl H. Seehoffer.

University of Michigan, School of Business Administration (six-year course, M.B.A.—accounting curriculum).
Ann Arbor; dean, C. E. Griffin.

Minnesota

University of Minnesota, School of Business Administration (four-year course, B.B.A.—major in accounting).
Minneapolis; dean, Russell A. Stevenson.

New York

College of the City of New York, School of Business and Civic Administration (four-year course, B.B.A.—accounting specialization; five-year course, M.B.A.).
New York; dean, Justin H. Moore.

Columbia University, School of Business (four-year course, B.S.; five-year course, M.S.).
New York; dean, Roswell C. McCrea.

Extension Department (B.S. in General Studies—major in accounting).
New York; director, James C. Egbert.

Fordham University, School of Business Administration (four-year day course, six-year evening course, B.S.).
New York; dean, Thomas C. Hughes.

Long Island University (four-year course, B.S. in accounting).
Brooklyn; dean, Tristram W. Metcalfe.

Manhattan College, School of Business (four-year course, B.B.A.).
New York; dean, James L. Fitzgerald.

New York University, School of Commerce (four-year day course, six-year evening course, B.S.—specialization in accounting; four-year day course, six-year evening course, B.C.S.—specialization in accounting).
New York; dean, John T. Madden.

Graduate School (five-year course, M.C.S., M.B.A.; six-year course, D.C.S.).
New York; dean, A. Wellington Taylor.

Niagara University, School of Business (four-year course, B.B.A.).
Niagara; dean, John R. Wilkinson.

Rensselaer Polytechnic Institute, Course in Business Administration (four-year course, B.S.).
Troy; dean, Roy Palmer Baker.

St. John's University, School of Accounting, Commerce and Finance (four-year course, B.B.A.).
Brooklyn; acting dean, George W. Matheson.

Syracuse University, College of Business Administration (four-year course, B.S.—in accounting).
Syracuse; dean, Charles L. Raper.

University of Buffalo, School of Business Administration (four-year course, B.B.A.).
Buffalo; dean, Clarence S. Marsh.

North Carolina

University of North Carolina, School of Commerce (four-year course, B.S. in Commerce—major in accounting).
Chapel Hill; dean, D. D. Carroll.

Ohio

Ohio State University, College of Commerce and Administration (four-year course, B.S. in B.A.—major in accounting).
Columbus; dean, Walter C. Weidler.

Pennsylvania

Grove City College (four-year course, B.S. in Commerce—accounting major).
Grove City; dean, Alva J. Calderwood.

Pennsylvania State College (Commerce and Finance Curriculum, four-year course, B.A.).
State College; dean, C. W. Stoddart.

Temple University, School of Commerce (four-year course, B.S. in Commerce—accounting major).
Philadelphia; dean, Milton F. Stauffer.

University of Pennsylvania, Wharton School of Finance and Commerce (four-year course, B.S. in Economics—major in accounting).
Philadelphia; dean, Joseph H. Willits.

University of Pittsburgh, School of Business Administration (four-year course, B.S.).
Pittsburgh; acting dean, A. H. Armbruster.

Villanova College, School of Commerce and Finance (four-year course, B.S. in Economics—major in accounting).
Villanova; dean, Rev. Joseph C. Bartley.

Tennessee

University of Tennessee, School of Commerce (four-year course, B.S. in Com.—curriculum in accounting).
Knoxville; head, Theodore W. Glocker.

Virginia

University of Virginia, McIntire School of Commerce (four-year course, B.S. in Com.).
University; head, Elbert A. Kincaid.

Wisconsin

Marquette University, College of Business Administration (four-year course, B.S. in B.A.).
Milwaukee; dean, John F. Pyle.

University of Wisconsin, School of Commerce (four-year course, B.A. and Ph.B.—major in accounting).
Madison; director, Chester L. Jones.

Wyoming

University of Wyoming, Commerce Division (four-year course, B.S.—accounting curriculum).
Laramie; head, E. Deane Hunton.

New York State was the first to enact an accountancy law. Her law has largely been the pattern for all later enactments. It has remained for her after thirty-eight years of administration of her statute to be the first state to prescribe systematic academic and professional training in approved institutions of learning as a basis for admission to the C.P.A. examinations. Already students are enrolled in registered courses in thirty-nine colleges and universities throughout the country who will upon graduation satisfy this requirement of our statute for admission to our C.P.A. examination. Thus we lead the nation in an effort to abandon the out-worn apprenticeship system of training public accountants and pave the way for synchronizing and coordinating teaching and examining and for admitting only soundly educated and professionally trained persons to the examination. Thus we herald the day when the economic waste and human slaughter of the present practice will disappear.

Failure of Candidates to Secure Proper Practical Experience

While the polyglot character of the academic and professional training of candidates for the C.P.A. certificate is perhaps the major reason for the high percentage of failures in the examinations another long-standing weakness in our requirements and procedure in New York State, characteristic of other states as well, has to be taken into serious account. It is urged every-

where that adequate preparation for the practice of public accountancy and admission to the examinations for the C.P.A. certificate, no matter what the scholastic training of the candidate, involve a period of practical experience. Our regulations oblige the candidate to have at least three years of experience in accountancy before entering the examination and a total of five years of experience before receiving the certificate. At least two of the required five years of experience must be in the office of a certified public accountant or the equivalent.

It is exceedingly difficult for candidates to find opportunities for the type of experience desired. Too often they are thrust into routine positions and given little perspective of the whole field of public accountancy. Hitherto, it has been believed mistakenly that the graduate of a four-year course in a school or college of accountancy and business administration safely could be given credit for the three preliminary years of practical experience required of other candidates. The records show that the college graduates taking advantage of this regulation do not do one whit better in the examinations than the other candidates. Of course, it must be borne in mind that the college graduates hitherto given credit for three years of experience have not necessarily had a major in accountancy. Under past practice any graduate of an approved school or college of accountancy or business administration has been given such recognition regardless of the scope and content of his course of study or the amount of work he may have had in accounting, commercial law and finance. The fact remains, however, and it sticks out like a sore thumb, that the college graduate has not yet distinguished himself in the examinations beyond the office trained candidate.

The Department has compiled the results of the C.P.A. examinations in this state for the academic years 1929 to 1934, or over a period of five years, and has compared the success of the college graduates with that of the non-college graduates. During this entire period the regulations required a candidate who failed in more than one subject to take all subjects over again. For candidates taking the full examination in theory of accounts, practical accounting, auditing and commercial law the record stands as follows:

Type of candidates	No. of candidates	Per cent passing all subjects	Per cent passing three subjects	Per cent passing two subjects	Per cent passing one subject	Per cent passing no subjects
College graduates	604	4	14	12	26	44
Non-college graduates	6,767	4	14	12	28	42

The figures have been rechecked carefully and it yet seems a strange coincident that the percentage of college graduates and of non-college graduates passing in all subjects, in three subjects, and in two subjects is identical while twenty-six per cent of college graduates and twenty-eight per cent of non-college graduates passed one subject and forty-four per cent of college graduates and forty-two per cent of non-college graduates passed no subjects.

Figures were compiled also for the college graduates and the non-college graduates taking one subject during this period. The results were as follows:

Candidates	Total No. of candidates	Per cent and No. passed (P) and failed (F)													
		Theory of accounts				Practical accounting				Auditing				Commercial law			
		P		F		P		F		P		F		P		F	
		%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.
College graduates.....	131	100	2	0	0	24	20	76	63	40	7	60	11	40	11	60	17
Non-college graduates..	3,599	55	91	45	75	22	608	78	2,140	40	144	60	217	75	526	25	173

It will be noted that all the college graduates and fifty-five per cent of the non-college graduates passed theory of accounts, that forty per cent of the college graduates and seventy-five per cent of the non-college graduates passed commercial law and that the success of the two groups was identical in auditing and very nearly so in practical accounting.

On the whole the record does not speak any too well for the college graduates but hasty conclusions must not be drawn from these figures nor instant condemnation made of the college courses they pursued. Graduates of seventeen outstanding colleges and universities were included in these figures. It must be remembered, as has already been indicated, that a major course in accountancy was not required of these candidates. The truth of the matter seems to be that the high mortality of the college graduates was due in part to inadequate practical experience and that the high mortality of the non-college graduates was due in part both to inadequate practical experience and to the lack of a sound academic background.

These examination results served to direct the attention of the Department anew to the procedures employed and the regulations in force for determining what constitutes satisfactory experience both for admission to the examinations and for completing the requirements for the certificate. The Council, the Board and the deans were called into conference upon this question also.

It was agreed that the college graduate should be obliged to present evidence of practical experience gained in the field for at least one year before being admitted to the examinations. Accordingly, the regulations of the commissioner of education were amended (regents meeting, March 15, 1934) so that graduation from college will hereafter give credit for only two years of the three years of experience required for admission to the examination. This means that no college graduate will be admitted hereafter to the examination without at least one year of office experience. It is believed by the Board that the college graduates of the future who come up for examinations with a major in accountancy to their credit and at least a year of office experience will give a very different account of themselves.

It was agreed by all our advisers also that greater scrutiny of the character and quality of the practical experience of all candidates should be exercised in the future. Hitherto, we have not known just what was meant by experience and have been guilty to some extent, in all candor it must be

acknowledged, for thirty-eight years of admitting candidates to the examination largely by noting the calendar length of their alleged experience. This easy-going method of admitting to the examination every one who could show that he had been employed in an accountant's office for three years, regardless of the nature of the employment, has served to admit hundreds of poorly qualified candidates and has been, in the judgment of many discriminating critics, the principal reason for the continued high mortality in the examinations. For years we have been examining over and over again hundreds of candidates without adequate experience. It is not surprising, therefore, that many of them in the unfortunate process have merely been thrusting their heads against a stone wall. Taking advantage of the ease with which admission could be secured to the examination, many young men have been taking the examination for the sake of the help it might give them in their pursuit of a certificate, for which they would readily admit themselves they were not qualified at the time.

In an effort to meet this weakness in our procedure the regulations of the commissioner of education touching admission to the C.P.A. examinations and the experience required therefor have been amended (regents meeting, May 17, 1934) and a definition of experience set up which reads as follows:

> "In all cases, experience acceptable for examination or certificate must be satisfactory to the Board of Examiners. The experience must have been sufficiently diversified in character to show some knowledge of accounting problems and systems of more than one type of business. This experience in private or public practice of accountancy must have been gained through work on general accounts, including preparation of balance sheets and operating statements, or through analyzing statements for credit or other purposes, or through auditing of accounts and tax returns. A reasonable portion of the experience required for the certificate must have been gained by the applicant in responsible work on diversified audit engagements."

Hereafter no candidate will be admitted to the examination who does not submit evidence of three years of experience acceptable under this definition. The strict enforcement of this definition undoubtedly will cut down the number of candidates admitted and result in a higher percentage of success in the examination.

This new definition will increase greatly the work of the Board of Examiners in the consideration of each individual application. Heretofore it was necessary only to compute the length of each applicant's experience as claimed by him. Now that the *quality* as well as the *length* of his experience must be investigated a more searching examination of his record becomes necessary. Accordingly, the rules of the Board have been changed to require a candidate to apply for admission not less than three months prior to the examination instead of not less than thirty days as heretofore (regents meeting, March 15, 1934). This revised rule will operate to give the Board sufficient time to inquire more fully into the quality of the experience of each candidate.

This effort to discover the quality of the experience offered by candidates

for admission to the C.P.A. examination has resulted in the preparation of new and entirely different application forms. The forms heretofore in use by the Department had become inadequate particularly in view of the new definition of experience. New forms have now been prepared with the cooperation of the Board of Examiners and put to use. They are much more comprehensive and call for much more detail than the old blanks and are calculated to give the examiners a much better line on the candidates and a much clearer picture of their qualifications. The use of these new forms will aid materially in admitting to the examination only such candidates as are really qualified and who may be reasonably expected to pass. The absence of such restrictions in the past has certainly been one of the contributing causes for the unhappy record of failures in the examination.

Examination Restrictions and Length of Papers

A minor cause for failure of many candidates to earn the C.P.A. certificate within a reasonable time, and thus another factor in the annual percentage of fatalities, it has been urged in many quarters, has been the strictness of the regulations of the commissioner of education in regard to reexamination by a candidate partially successful in his first trial. In general a candidate who takes a complete licensing examination and fails in more than one written subject must take the entire examination again. An exception has been made (regents meeting, March 15, 1934) which is calculated deliberately to be beneficial to the C.P.A. candidate. It allows greater latitude in failures but also obliges the candidate obviously inadequately prepared to take reexaminations and to spend some time in further preparation after conspicuous failure. The revised regulation reads as follows:

> "In certified public accountancy a candidate who passes the subject of practical accounting need not be reexamined in that subject. A candidate who passes two subjects in any one examination need not be reexamined in said two subjects. A candidate who fails in more than two subjects in any one examination shall not be readmitted to the examination until one year has elapsed."

Another cause for failures, it has been urged widely by candidates, has been the length of the examination papers. For some time a large proportion of the complaints of candidates has centered on the examination in practical accounting. The chief burden of the complaint has been that the examination has been too long and that it has been almost impossible to answer the questions adequately in the time given. Careful investigation convinced the Department that the complaints have not been without some justification. Accordingly, a conference was called in which the chancellor of the university, the Board of Examiners, the Council on Accountancy and Department officials participated. It was decided finally to revise completely both parts of the examination and to change its character materially. Hereafter part I will consist of but one problem with an option and part II will consist of a series of questions on fundamentals instead of two long problems. The Department is confident that this change will remove a real cause for complaint as to the length and character of this examination and will increase materially the proportion of candidates who pass it.

It is entirely possible, of course, that other papers in the examination are also too long and call for more than the qualified candidate can accomplish in the time allotted. That is a mistake which well intentioned examiners sometimes make. The Department proposes to give special attention to the operation of the time requirements in subsequent C.P.A. examinations.

Candidates Not Fully Informed As to Scope of Examination

Candidates for licenses in other professions in which graduation from a professional school is required are usually well informed as to the scope and character of the licensing examination. Their whole academic and professional training has been to some extent a preparation for the examination. All our professional boards of examiners undertake to set examinations with an eye to the training the candidates have received. To this end within the last year or two professional boards and college deans in architecture, engineering, dentistry and medicine have been called into joint conferences by the Department so as to correlate teaching and examining within reasonable bounds. It has been interesting in all these conferences to see the instant agreement among teachers and examiners that teaching is more important than examining and that the function of a state board of examiners is not so much to find what a candidate knows as to find what he can do with what he knows. All agree that the major object of teaching in a professional school is not the mere preparation of students to pass licensing examinations and that sound teaching can not proceed upon any such basis.

These considerations, however, must not blind us to the fact that our examinations in accountancy are as yet on a different basis from all of our other professional examinations. There is as yet no required college or professional course to guide the candidate in any way in his preparation for the C.P.A. examination.

In the absence of systematic required collegiate training as a basis for admission to the C.P.A. examination, recognizing the need of a definite guide for candidates preparing themselves for the examination, the regents caused a certified public accountant syllabus to be prepared and published in 1900. It was written by Charles W. Haskins, a member of the first Board of Examiners and then president of the Board. The syllabus was designed to provide a

> "systematic statement of the scope of the examinations, accompanied by an outline of the sub-topics of which the candidate is required to have general or specific knowledge."

This syllabus was reissued in 1903 and in 1907. A revision of the original syllabus was published in 1911 and reissued in 1912. The last edition has been long out of print and in the meantime many changes have been made in the scope and content of C.P.A. examinations in New York as well as in other states. Candidates in New York State preparing themselves in offices have thus been without dependable advice upon what the state expects of them. This failure of the Department to keep available at all times a syllabus consonant with the development of the examinations, has no doubt contributed to some extent to the high percentage of failures.

Work Started on New Syllabus

Discovering this situation shortly after being appointed assistant commissioner for higher education in June, 1931, the author at once took steps to secure a new syllabus. The task has been a difficult one especially in the light of the statutory requirement that all candidates for admission to the examination after January 1, 1938 must be graduates of approved courses in schools or colleges of accountancy. Accordingly, a syllabus was projected which would serve the dual purpose of setting up a guide for the candidates preparing themselves in offices prior to 1938 and as notice to the colleges of the nature of the course of study the Department would expect them to offer for registration. Without special funds with which to prosecute this undertaking, the Department has been obliged to depend upon the Board, the Council and college deans and professors for such time as they have been able to give to the work. All have cooperated generously. The original draft was prepared by the Board, the arduous burden of formulating the syllabus being borne largely by George E. Bennett, professor at Syracuse University, a member of the Board.

The original draft of the syllabus proposed by the Board of Examiners was submitted to the Council on Accountancy and was then revised by a joint committee of these two bodies and submitted by the Department on March 25, 1933 to the faculties of all the schools and colleges of accountancy and business administration in the state for their criticisms and suggestions. So many constructive proposals were advanced by the schools and colleges that it seemed imperative to undertake further revision of the syllabus as a whole. This task was committed to Norman E. Webster, chairman of the Board of Examiners and to John T. Madden, dean of the School of Commerce, Accounts and Finance of New York University and secretary of the Council on Accountancy. Their labors are about completed now and the syllabus will soon be ready for presentation to the regents for their approval.

The syllabus is, of course, long overdue, but it has been difficult under the conditions described to push it forward any more rapidly. It now represents an honest effort to outline specifically what knowledge and training are expected of a candidate for admission to the C.P.A. examination and is representative of the views of examiners, of active practitioners of public accountancy and of college teachers in this field. Its early publication will meet a need which candidates have felt strongly for many years and it is believed by those most active in its preparation that its usefulness will be reflected in a higher percentage of success in the examinations.

Examinations Too Difficult and Rated Too Severely

It is of course natural that the high percentage of failures in C.P.A. examinations, in New York State, as well as throughout the country, should in many quarters be attributed to papers that are too difficult and ratings that are too critical. That is the view which candidates who fail in any licensing examination are apt to take. It would be difficult indeed to find any

court or jury able to determine just when an examination is too difficult and when it is rated too severely.

In the last analysis, and properly so, each profession determines its professional standards. Doctors prepare and rate the question papers in medical licensing examinations and the American Medical Association and the American Association of Medical Colleges largely determine the academic and professional requirements which are prescribed by governmental agencies for admission to licensing examinations. Lawyers prepare and rate the question papers in bar examinations and in like manner the American Bar Association and the American Association of Colleges of Law strongly influence the standards set up by the several states for admission to the bar.

In accountancy there is as yet no educational standardizing agency on a national scale, and there is not likely to be one until the majority of the states put accountancy on a genuine professional basis as New York State will do after January 1, 1938. Powerful agencies have developed, however, within the profession. The American Institute of Accountants and the American Society of Certified Public Accountants, and many state societies have developed professional ideals and standards comparable in many ways with those of medicine and law. The International Congress on Accounting holding sessions every few years brings together distinguished accountants from all over the world and its papers and proceedings take rank with those of other international professional congresses.

The American Institute of Accountants, as has already been indicated, prepares examination papers for the C.P.A. certificate which are accepted and adopted as their own by thirty-five states. Five states conduct their own examinations and eight are conducted by the American Society. The mortality in all these examining centers, as we have seen, is high as compared with that of other professional licensing examinations.

Praises Ideals of Board of Examiners

If it is now alleged and assumed that our Board is too severe and critical in the examinations it sets and in the ratings it gives examination papers, a like indictment must be made against all similar examining boards. Can we sustain an indictment against an entire profession? Can we give serious ear to the charge, often made by disappointed candidates, that certified public accountants and the examining boards throughout the country have entered into a gigantic conspiracy to limit the number possessing the C.P.A. certificate and so set examinations which are unfair and unreasonable? Must we not give to our Board of Certified Public Accountant Examiners the same liberty we give other professional boards? Can any lay agency determine the professional standards in accountancy?

One who has had intimate contact with many professional boards finds our Board of Certified Public Accountant Examiners inspired by the ideals and guided by the devotion to public service fortunately characteristic of all our other professional boards. Throughout the thirty-eight years the accountancy law has been in force the Department has always been fortunate in the intelligence, probity and representative character of the members of

the Board. It would be difficult for the most exacting critic to prove that the Board through its history has not always acted conscientiously, honestly and with intended justice. The Board may at times fall into the dangerous habit of setting examinations on the false assumption that the candidates have a knowledge and training equal to their own, forgetting that the candidates are mainly beginners who will be more efficient as they grow older in successful practice. It might be well to call in from time to time a professional jury of college instructors in accountancy and allied subjects, experienced certified public accountants, and perhaps technical educational experts to inquire anew what it is we expect a candidate to know and to be able to do and how closely the examinations square with this expectation. It might also be helpful now and then to ask such advisers to rate independently groups of papers to see how closely their judgment paralleled that of the examiners. Such a plan could be undertaken only as a check and a guide and without reflection upon the Board. No two groups of examiners, it is well known, ever agree fully upon ratings. We must accept the findings of the Board of Examiners in authority and we must respect the judgment of the Board if we expect to retain its services.

It is sometimes suggested where the mortality is great in an examination that the passing mark be lowered. This artificial method of trying to increase the number who get through does not work out in practice. The passing mark in regents examinations in the last thirty years has been shifted about from seventy-five to sixty and back to sixty-five. For many years with almost clock-like regularity, regardless of the passing mark, the percentage of mortality was close around thirty. It is well known that the mark does not control. What takes place in the mind of the examiner controls. There would be no assurance that a change in our passing mark in C.P.A. examinations from seventy-five to sixty, for instance, would result after readjustments were made, in any material difference in the percentage of successful candidates. Moreover, such a step would be regarded as a definite declaration of lack of faith in our examiners.

Considers Existing Conditions Intolerable

All these considerations aside, the fact remains that the existing situation is intolerable. Nobody can defend the wasteful and purposeless process of examining candidates over and over again and of rejecting at each examination the overwhelming majority of those who sit in it. It is to be remembered, however, that we have tolerated this *intolerable* situation in this state for thirty-eight years. In 1902-1903, eighty-five per cent of the candidates sitting in the C.P.A. examination were rejected, just two per cent more than were rejected in April, 1934. If it were possible to bring a wholesale indictment for this situation against any one agency or group of agencies, the profession, the colleges, the education departments, and the boards of examiners throughout the country would have to be put on trial. All these agencies until recent years have shown a singular lack of concern about the continued slaughter. The major blame for a national situation which has

prevailed for many years cannot now be laid at the door of our Board of Examiners.

We are the only state in the union that has declared that it does not propose to tolerate an intolerable situation much longer. It is submitted that major reasons for the long continued high mortality in the examinations lie wholly outside the question papers and the rating of them and that the steps we have taken already by statute and by revised regulations and procedures will in due time put the accountancy examination results on a comparable basis with those in medicine and dentistry.

To review briefly, those steps may be restated as follows:

1. The amended statute requiring a candidate for admission to the C.P.A. examination after January 1, 1938, to be a graduate of an approved course in a school or college of accountancy is the most promising step yet taken in America toward putting accountancy on a professional basis.
2. The establishment of a four-year college course with a major in accountancy and the registration of such a course in thirty-nine colleges and universities throughout the country gives assurance that a homogeneous group of candidates with basically sound academic and professional training will be coming up for examination after January 1, 1938.
3. College graduates will be required henceforth to present evidence of at least one year of practical office experience before being admitted to the examination.
4. All candidates will be subjected to careful inquiry as to the scope and character of their practical experience and will not be admitted to the examination if their experience does not satisfy the new definition of what constitutes satisfactory experience.
5. The question paper in practical accounting has been modified to meet the charge that it has been too long.
6. The regulations have been changed to allow credit once earned in practical accounting or in any two subjects to stand so that the candidate is not obliged to repeat those subjects.
7. A new syllabus is about to be issued to serve as a guide to candidates preparing themselves for examination between now and January 1, 1938.
8. The Board of Examiners has been requested to survey its own practices in the preparation of question papers and in the rating of answers to make sure that they are pitching the examination at a fair level to test candidates who are about to be admitted to a profession. The ideal which we have a right to suggest for practical realization to our Board of Examiners was stated admirably in this language in an editorial in the October, 1919, issue of the *Journal of Accountancy* (p. 288) in a discussion of the Institute's examinations:

"Has the Institute's Board attained the desired result? The answer to this question lies chiefly in the fact that the Board has kept ever in mind that the young men and women in the profession have not and cannot have had quite so broad and comprehensive an experience as the examiners themselves. The objective seems to be a friendly inquiry into the candidate's ability and knowledge, not expecting or demanding

the breadth of vision which can only be attained through many years of experience, but insisting resolutely that there be a proper foundation on which to build—a foundation whereon the profession in the coming years may rest secure."

No one expects that the full effect of the revised regulations and procedures will be felt until the amended statute is in full operation, but that the long-continued intolerable situation will become relatively more tolerable with each subsequent examination in the next three or four years is the firm belief of those who have had most to do on the firing line with the undertakings here described.

Important Income Tax Decisions of the Past Year

By WALTER A. STAUB, C. P. A.

THE average layman, I think, has the impression that when the Congress passes a tax statute the basis of the new tax is established and he, more or less, assumes that all that remains is to collect the tax in the routine manner prescribed in the act. Those who have had experience with tax matters, as practically every accountant has, know that the passing of a statute such as the Revenue Act of 1934 is merely the beginning of the proceeding and that, as a matter of fact, years elapse before it is finally known what Congress actually did in passing an act.

In our country, the courts may set aside acts of legislative bodies on the ground that they are unconstitutional. That alone introduces a considerable factor of uncertainty with respect to various provisions of the taxing act. Aside from the question of constitutionality, many other provisions must be passed on by the courts before it is certain or definite just what the effect is of the attempted action by the legislative body.

In our tax meetings from year to year an important part of the presentation and discussion has been with respect to decisions made by the courts and the Board of Tax Appeals, and sometimes the regulations and rulings made by the Treasury Department, since the last sessions on taxation. Therefore I want to touch on a few such decisions and rulings in an endeavor to see how matters affecting past acts may possibly affect the 1934 Revenue Act, because of similar provisions being in the several acts. I shall begin with some references to cases that primarily affect individuals.

Sales to Establish Losses

Over the years, one of the practices under our revenue acts that has attracted perhaps more attention than any other, particularly during the past year, is that relating to so-called tax sales. In many cases a taxpayer owned securities which had depreciated in value, but, for one reason or another, the taxpayer either did not wish to, or could not, make a sale to outside interests, and accordingly, he made a sale, perhaps to a member of his family, to a corporation in which he was interested, to a friend, or in some other way which raised a question in the mind of the Treasury as to whether it was such a sale as complied with the requirements of the law respecting losses sustained on sales, or which raised a question as to the bona fides of the transaction.

Due to the continued attention given to this subject, and particularly to the developments in the hearings conducted last winter by the Senate Committee on Banking and Currency (which revealed to the public what was known to tax practitioners, viz; that there had been extensive deductions for losses on so-called tax sales), the 1934 Act contains a provision which disallows any deduction for losses on sales of securities between members of a family.

New Deal Seen Reflected in Treasury's Attitude

Of course, that provision applies only to the returns that will be made under the 1934 Act. That Act, however, and perhaps the New Deal, inspired the Treasury to go further I think, than it has in the past in disallowing losses on sales between parties who might in any sense be considered as not dealing at arm's length and, in a measure, it seems to me the Treasury is endeavoring to apply retroactively the provision of the 1934 Act just referred to, which precludes the deduction of a loss on the sale of securities made to a member of one's family or to a controlled corporation.

In considering how successful the Treasury might be in attempting to apply retroactively this section, not literally but in spirit, I was interested in a case that was decided last year but which seemed to me to express so well the attitude of the courts on the matter of losses on tax sales, particularly where the relations between the buying and selling parties were very close, because the courts will finally decide the cases that are appealed from the Treasury's tentative retroactive action.

I call your attention to the case of Richard W. Hale, an eminent member of the Boston bar, a man about whose integrity there would not be the slightest question (*Com'r* v. *Hale*) (67 F. (2d) 561). The transaction involved in this case occurred in 1926. Mr. Hale wrote to his wife:

> I wish to sell you the following shares in the Moa Bay Iron Company, and to be quite frank about the purpose and make this record of the whole matter.
>
> I sell you these shares with no string. They cease to be mine and become yours. Thus I establish a loss for income tax purposes.
>
> I fix the price at $1.25 per share. There is no one known to me who would pay that or more. The market has been tested in the auctions by others. Also there have been other sales on this basis or nearly so. While the stockholders have great hopes, those hopes are not reflected in the price obtainable, but only — as here — in making the seller wish to have the purchaser some one whose good fortune would be agreeable.

He said, "I fix the price at $1.25 per share." In reply his wife wrote as follows, her communication being even more terse than his:

> In reply to your letter of October 23rd, I enclose check for $1.250, in payment for the shares in the Moa Bay Iron Company.

The stock was duly transferred, and stamp taxes paid. The commissioner thought he had a basis on which to disallow the loss claimed by Mr. Hale on this sale. He did not, however, challenge the deductibilty of the loss on the ground that the sale was not bona fide, or that it was the purpose of the sale to establish a loss for income tax purposes, but on the ground that a wife could not, under the laws of Massachusetts, make contracts with her husband.

Analyzes Court Opinion on Tax Loss Sale

It is interesting to see what the court said about that. The court stated that "it would seem to be a fair inference that while under the Act of 1884 a married woman might not hold property if transferred direct from her husband, there was no longer, after the Act of 1920, any prohibition against it,

once she had acquired title to it, though an executory contract between them to convey, was, under section 2, still void and could not be enforced, unless attended with some equitable consideration."

The following conclusion is particularly interesting: "But even under decisions of the Massachusetts court and the statutes of that commonwealth, we think that the title to the shares of stock has passed beyond the appellee's control under the circumstances shown to exist in this case. He has received full value therefor and from his wife's separate property."

I want to call your attention to the various points in the summing up of this case that indicate some of the tests that the court will make to determine whether or not there has been a bona fide sale, and whether the loss may properly be deducted. "He has received full value therefor and from his wife's separate property." He was not merely dealing with himself. "She has a right to hold shares of stock in her own right, free of any control by her husband. He retained no beneficial interest in the property." Note that. "There was no intent that she should hold the shares as trustee for him; he expressly stipulated that they were to be conveyed absolutely and unconditionally." He did not have such a string as would enable him to pull the stock back from her whenever he pleased, or perhaps pull it back at the price he received. "No fraud or coercion was practiced on either. We think the shares of stock may be treated as though conveyed to her separate use."

"Having thus acquired the property for full value, we think she may hold it under section 1 of chapter 209, General Laws of Massachusetts, unless the husband can show some equitable considerations by reason of which he is entitled in equity to recover it, and the record disclosed no such equitable considerations. He has sustained an actual loss by the transfer as fully as though he had conveyed it for the same sum to a stranger."

Particularly note these two concluding paragraphs, "the mere fact that the transfer was made by the appellee for the avowed purpose of reducing his income tax does not render it invalid, when the sum received was equal to what could otherwise be obtained from other parties, as in this case.

"To hold such transfers are valid to create deductible losses in computing income taxes may furnish opportunity for fraud upon the government, and courts will require clear proof that the transaction was bona fide and not a subterfuge, and that full value was paid; but when, as in this case, it is conceded that full value was paid and from the separate property of the wife, we think a deductible loss occurred under section 214 (a) (5) of the Revenue Act of 1926."

Recent Decision Important as Clue to Future Cases

It is interesting to note that within the last few weeks the Board of Tax Appeals held in *Arguimbeau* v. *Com'r* (31 B.T.A. 124) that a loss on the sale of stock by the wife was deductible despite concurrent purchase by the husband. That was prior to the 1934 Act. There are still many cases that are open under the 1932 Act. These decisions are important as pointing to what may be expected if these cases will stand inspection as to their bona fides. In the Arguimbeau case a like number of shares of the same stock was purchased

through the same broker on the same day by the husband, a son acting as agent for both husband and wife. Furthermore, a joint return was filed.

On November 1, 1934, the Treasury by I. T. 2824 revoked I. T. 1997, which had held that a security transaction by husband and wife in a joint return should be treated as a transaction of one individual in the application of the thirty-day wash sale provision. This revocation is in line with the decision of the Board of Tax Appeals in *Gummey* v. *Com'r* (26 B.T.A. 894) which was promulgated on August 29, 1932 and which has now been acquiesced in by the commissioner (XIII-43-7086). There it was held that each of the two taxpayers should be treated as an individual taxpayer.

The Board made another decision on September 5, 1934, to the same general effect. In *Fawsett* v. *Com'r* (31 B.T.A. 30), and in *Uihlein* v. *Com'r* (30 B.T.A. 399) the Board allowed a loss on a direct sale from husband to wife, though a joint return was filed. The commissioner has indicated his non-acquiescence in this decision of the Board.

Purchase of Bonds in Default

In a recent Board of Tax Appeals decision, *Hewitt* v. *Com'r* (30 B.T.A. 150) where a taxpayer purchased bonds with defaulted matured interest coupons attached, it was held that the subsequent collection of some of the coupons did not constitute income. The Treasury claimed that any collection of interest was income, but the Board took the position that the taxpayer paid a certain price for the principal and defaulted coupons and the collection of such coupons was a partial recovery of principal.

Stocks Acquired Through Rights

In determining the period for which stock acquired through the exercise of rights has been held, the Treasury now takes the position that the period starts from the date the new stock is acquired (G.C.M. 12942, XIII-16-6755). You will remember that formerly it was held that the period ran from the acquisition of the original stock with respect to which the rights were exercised. This is an important change.

Limitation on Contributions

Another point that affects the returns of individuals and which has been finally decided after a great many conflicting rulings and decisions is the treatment of capital gains under the acts preceding 1934 in determining the limitation on deductible charitable contributions. You will recall that the limitation is fifteen per cent of the net income before deducting the contributions. On November 5, 1934, the United States Supreme Court decided in *Com'r* v. *Bliss* and *Com'r* v. *Harbison* that the capital gains, which were subject to the twelve and a half per cent tax should be added to the net income from ordinary sources in determining the fifteen per cent limitation. There has not yet been a decision of the Supreme Court with respect to the deduction of a net capital loss, but it seems entirely probable that eventually it will be held that the capital net loss must be deducted from the net income from ordinary sources.

Dividends

The Board of Tax Appeals has held, in *Stifel* v. *Com'r* (29 B.T.A. 1145), that a distribution made while a corporation has an operating deficit is not taxable even though the corporation has a paid-in surplus and current earnings. The commissioner has non-acquiesced in the decision, his position being that the paid-in surplus offsets the deficit, and that, consequently, if there are earnings the dividends should be deemed to be paid therefrom. The Board's decision is important because in many cases where a corporation has during the depression period reduced capital stock for the purpose of applying capital surplus against deficits in order to continue paying dividends, it may have been overlooked that the dividends now being paid are really paid from capital, and should be non-taxable.

Here is a matter that involves perhaps not a great deal in money, but it is well to have a final decision on the point. The Supreme Court reversed the Circuit Court of Appeals for the Seventh Circuit, in *Avery* v. *Com'r* (292 U.S. 210), and held that when a dividend was payable December 31 and the checks were signed December 31 but not distributed until January 1, they were not taxable until the year in which they were distributed. The commissioner claimed the constructive receipt theory. It is interesting to see how two courts, each one of them with presumably very learned and able judges, as the Supreme Court on the one side and the Circuit Court of Appeals on the other side, took directly opposed views of that question.

Stock Exchange Sales on December 31

Another decision, this time in (G.C.M. 12570, XIII-5-6625), which also touches on the turn of the year, is that when taxpayers make sales of securities on a stock exchange on the last day of the year and delivery is not made in the regular way until the following year, the loss is not deductible until the following year. A cash sale must be made to secure the loss in the earlier year. That is not a particularly new thought, but it may be worth mentioning and emphasizing that it is not sufficient simply to have contracted for the sale on the last day of the year, but it must actually be carried out before the year closes in order to secure the deduction in that year's return.

On November 7, 1934, the Board held in *Appleby* v. *Com'r* (31 B.T.A. 109), that where a broker sold stock on December 30, 1930, pursuant to the taxpayer's instructions, but through inadvertence the stock was not delivered to the broker by the taxpayer until his return from a holiday on January 5, 1931, the loss was, nevertheless, deductible in 1930. This decision is contrary to the general trend, and may rest upon the peculiar facts in that particular case.

Refunding of Bonds

On the exchange of old bonds for new, I think most of us would be inclined to think that a taxpayer had not made very much by exchanging bonds where he still has the same obligor as before, the same amount of principal, and so on. The question, however, is of importance and I suppose some taxpayers may feel that they had made a loss even though there has not been a change in the face amount of the bonds.

There have been many cases in the past year or two where corporations or municipalities have been unable to pay their bonds at maturity and have issued new bonds in exchange for old. The Treasury has held uniformly that these exchanges are closed transactions resulting in gain or loss (I.T. 2035, III-I C.B. 55, and other rulings). The same rule has been applied to the exchange of United States bonds for new issues.

In a curious ruling (I.T. 2778, XIII-18-6773), the Treasury has held that when debentures were exchanged for a new issue, and the only differences between the two were the dates of issue and the amounts to be redeemed annually, gains from the exchange should be taxed but losses should be disallowed on the theory that substantially identical securities were acquired and the wash sale provisions were, accordingly, applicable. It is difficult to see how there could be any gain if the two issues are assumed to be substantially identical.

Basis of Securities

Quite recently the Board of Tax Appeals made a decision in *Oliver* v. *Com'r* (30 B.T.A. 208) with respect to the basis of stock received in a non-taxable exchange where the original stock was acquired at different times and at different prices. The Board held that the first-in, first-out rule does not apply to stock received upon an exchange in a reorganization nor to stock received in an exchange of stock for stock of the same corporation in a non-taxable exchange. In such cases the board holds that the basis of the total original shares should be allocated equally to the new shares. In other words, an average cost must be used.

There is some question as to how sound this decision may be, and it may also be rather confusing because, in determining the period for which the new shares are held for applying percentages under the capital gains and losses section of the 1934 Act, the new stock must be related back to the original stock and accordingly there would be one basis for determining the period held and another basis for determining the cost.

Constructive Receipt

A theory which the Treasury has developed continually over the years is that of constructive receipt. In the case of *Mott* v. *Com'r* (30 B.T.A. 160), the taxpayer had created certain trusts in 1919. He had named himself as trustee and it was provided that he was entitled to deduct and retain annually three per cent of the gross income of the trust as compensation for his services as trustee. In fact, however, he did not make the claim and, as has been done in many cases, he rendered his services without making a charge. The taxpayer was on the cash basis and reported no income from this source.

The Treasury took the position that a contractual right to receive the commission or percentage of the gross income existed and that consequently the income had been received constructively. In substance, the Treasury held that Mr. Mott had made a gift of the commissions if he did not take them. But the Board held otherwise, and stated: "To say that petitioner received these amounts as compensation is to indulge in a deliberate legal fiction.

Petitioner had the right to render his services free if he wished, and we know of no rule of law which requires a person to accept compensation or income. The fiction of constructive receipt of income is resorted to usually to fix the time of receipt, where it is ultimately actually received and accepted."

It is rather interesting to note the Board's statement as to the usual purpose of imputing constructive receipt: that it is for the purpose of fixing a time when a transaction actually taxable in itself is to be taxed and not to impute the receipt of income where income has not been actually received.

Loss on Personal Assets

An interesting matter that does not represent a decision but may possibly be a question that will be raised eventually under the 1934 Act is the possible deductibility of losses on the sale of personal residences or other property held for personal use. In the 1932 law "capital loss" was defined as "deductible loss", and "capital deductions" as "such deductions as are allowed by section 23". The 1934 law does not restrict specifically losses from sales or exchanges of capital assets to losses which are deductible under section 23 (e). It may accordingly be urged that losses on the sale of personal residences, automobiles, jewelry, and so forth, are deductible from capital gains. I will not attempt to cite the various law sections, but call attention to 23 (e), 23 (j), 117 (b) and 117 (d).

Personally, I think it unlikely that the losses will be allowed, but I am suggesting the question for study by any who expect to make a loss on the next conversion of an automobile, or who may sell a house at a loss. One might look into it to see if a deduction for the loss can be secured.

Effect of Taxpayer's Motives

An important development in the decisions of the Board of Tax Appeals and of the courts in the last year or so is that of looking behind the form of the transaction and endeavoring to determine the taxpayer's motives in setting up the transaction and in carrying it through. One case is that of *Com'r* v. *Gregory* (69 F. (2d) 809) where the taxpayer (an individual) was the sole stockholder of a corporation and desired the sale of some of its properties at a profit. Had the corporation made the sale, it would have had to pay a tax on the profit and then, if the profit were distributed to the sole stockholder, she would have had to pay a surtax on the dividend. The property of existing corporation X was transferred to a newly organized corporation Y in exchange for all of the latter's capital stock, which stock was then distributed to the sole stockholder of corporation X. The Y corporation was liquidated then and the sole stockholder received the property, which she thereafter sold, paying only a capital gain tax at twelve and a half per cent.

The admitted purpose of the transaction was to avoid any tax to the corporation X on the sale of the property and to minimize the tax to the sole stockholder. The series of transfers fell literally within the reorganization sections of the law then in effect. The court reversed the Board and held that there was no reorganization within the meaning of the statute on the

ground that "to dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations'." The case is now pending before the Supreme Court. [Ed.: The decision of the Circuit Court of Appeals was affirmed by the U. S. Supreme Court on January 7, 1935.]

Another case in which the Board of Tax Appeals have consideration to the motive of the taxpayer in following a procedure permissible under the law is that of *Chisholm* v. *Com'r* (29 B.T.A. 1334). The taxpayers gave an option for the sale of corporate stock and, after receiving notice of the optionee's election to exercise it, the taxpayers, who owned the stock, in order to escape profit on the sale, organized a partnership consisting only of themselves to which they transferred title to their stock and then caused the partnership to transfer title to the purchaser and receive the proceeds.

Although the Board had previously held that the basis of property contributed to a partnership is the fair value when contributed, (*Archibald* v. *Com'r*) (27 B.T.A. 837), which was affirmed by the Circuit Court and certiorari denied by the Supreme Court, the Board held that in this case the transitory holding of title to the property by the partnership should not be regarded as a matter of substance and that the sale should be treated as a sale by the individuals.

It will be interesting to see what finally happens in that case. It was in that case that Judge Goodrich filed a vigorous dissenting opinion which makes interesting reading and which takes a decided exception to the decision of the majority that the taxpayer's motives are to be a deciding element in determining the taxability of a transaction which in all other respects meets the requirements of the law.

Incidentally, the majority opinion seems to run counter to the various court decisions of the past which have held repeatedly that a taxpayer is justified in doing, and that the business man, in fact, does do, all that he can do properly under the law to minimize his tax.

In the Supreme Court, Justice Holmes once said that when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally than a party who has availed himself to the full of what the law permits (*Bullen* v. *Wisconsin*) (240 U. S. 625).

Investment Expenses

There has been, at times, some uncertainty as to the deductibility of expenses by a person whose income is derived entirely from the holding of investments. In a letter dated January 4, 1934, to the Committee of Banking Institutions on Taxation, the commissioner stated that "you are advised that the Bureau has recently adopted the policy of allowing as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year with respect to the management, protection and handling of properties producing taxable income."

That ought to leave no question as to the deductibility, for instance, of fees paid to trust companies for custodian service and collection of income from investments and similar transactions.

Estoppel

Leaving now this group of cases and decisions which have applied much more to individuals than any other one class of taxpayers, I want to consider, very briefly, a general question which may affect either individuals or corporations, and that is the question of estoppel. I realize that this is a question primarily of law rather than of accounting, and yet it is naturally of interest to us because of its affect on our clients and also because of the fact that it may, at times, upset what the accountant may determine is the correct taxable income in a given case.

The Board of Tax Appeals particularly used to stress the proposition that each year's return must stand on its own feet and that the mere fact that a certain transaction had been included in the return of a previous year did not mean it could not be included in the year under review if it, in fact, belonged there. Vice versa, if in some previous year a taxpayer had failed to get a deduction to which he was entitled and thought to get it in a later year, he could not have it, because it could apply only to the year in which the events giving rise to the deduction occurred.

The courts, in many cases, have upheld the Treasury during the last several years in its invocation of estoppel against the taxpayer. This tendency has been particularly conspicuous where the statute of limitations has been an issue raised by the taxpayer.

For instance, the failure to report as income over the life of the lease the value of improvements made by the lessee has been deemed to be a representation that no income was realized, and, therefore, when the property was sold the value of the improvements was not permitted to be added to the lessor's basis (*Crane* v. *Com'r*) (68 F (2d) 640).

In *Moran* v. *Com'r* (67 F (2d) 601), the failure to report income constructively received was also construed as an election to consider the income realized only when received.

A true election is the exercise of a choice between two available courses. Whether the decisions rely on estoppel or on the statement that the theory of constructive receipt cannot be applied retroactively to the detriment of the public revenue, the net effect is the nullification of the statute of limitations as it would otherwise apply to the case.

Where the taxpayer has already taken an unauthorized deduction and it is held that he is then precluded from the usual amortization allowances (*B. & O. R.R. Co.* v. *Com'r*) (30 B.T.A. 194), (*Wheelock* v. *Com'r*) (28 B.T.A. 611), the denial of recovery is more justifiable than in some of the other cases, as the taxpayer cannot be said to be seeking to recover something of which he has been wrongfully deprived. He has had the deduction once; therefore, there is a certain equity in not allowing it again.

It is now settled that if a taxpayer requests that collection of a deficiency for one year be suspended until a return for a later year is audited, and an over-assessment determined within the statutory period for the later year is then credited against the deficiency for the earlier year after the limitation

period on collection has expired for the earlier year, the taxpayer is estopped from contesting the legality of the credit (*R. H. Stearns Co.* v. *U. S.*) (54 S. Ct. 325).

Other Cases and Related Opinion of Board Member

In *Stern Brothers* v. *U. S.*, which was decided last month in the Court of Claims, the taxpayer had deducted thirteen months of rental in a return for the year ended January 31, 1929, and eleven months in the return for the following fiscal year. A claim for refund was filed with respect to the second year (that is, the return for the year ended January 31, 1930) on the ground that the company had failed to take a deduction in that year for the rental for the month of February, 1929, the first month of the fiscal year and therefore, was, entitled to further deduction and consequently to a refund of a portion of the tax paid. The refund claim, however, was filed after the time had expired for additional assessment by the commissioner with respect to the earlier year, and the court refused to allow the claim on the ground that this taxpayer had all he was entitled to. There was no substantial difference between the amount of additional tax paid in the one year and the refund claimed for the succeeding year, and under those circumstances there was in effect an estoppel against the corporation.

It is interesting to note that the Board of Tax Appeals which had, through a one-man decision, earlier in the year applied estoppel in the case of *Sugar Creek Coal and Mining Company* v. *Com'r,* (30 B.T.A. 420), in October of this year reversed that decision and held that in this case estoppel in effect, would set aside the statute of limitations and that there was no warrant for doing so in the case. I shall not attempt to cite the entire decision, interesting as it is. However, I want to give just a few sentences from it.

Mr. Sternhagen, member of Board of Tax Appeals, said that "estoppel is not an element of income but only a doctrine affecting liability." Then later he stated that "the burden is upon the party asserting it to establish both the facts relied on to support it and the necessity in fairness for its applicaton." "This the commissioner has assumed and undertaken." Then he goes on to state the commissioner's proposition which is that the "taxpayer who, for a long period of years beginning prior to 1913, annually receives taxable income and erroneously (but not fraudulently) omits it from his return and is not required by the commissioner to pay tax thereon, although official examinations have for a number of years informed the commissioner of the facts before the expiration of the statutory period of limitations, is estopped to deny liability for tax on the aggregate amount of such income in a single subsequent year, when such income is neither received nor accrued, because the statute of limitations bars the tax for the earlier years when it was properly due."

"This proposition would operate as a complete frustration of the statute of limitations. . . ." "A mutual mistake of law is no foundation for estoppel." In effect, the Board takes the position that both parties probably erred over this long period of years, but, that being the case, the statute of limitations has run and neither of them can reopen it.

The concluding sentence is of interest, and that is: "And the doctrine of estoppel is not to be confused with that of election."

Accumulation of Earnings

Among the questions or communications which came to the office of the Society in preparation for its 1934 tax conference, were one or more requests that some reference be made to section 102 of the Revenue Act of 1934. That section, as you recall, deals with a penalty tax, or surtax as it is now called, upon adjusted net income where the taxpayer corporation has been formed or availed of to prevent the imposition of the surtax upon its shareholders through the medium of permitting earnings to accumulate instead of being distributed.

There have been some decisions under the corresponding provision of previous acts, but they are not 100 per cent precedents to be applied under the 1934 Act because, as you will recall, under all the acts prior to 1934 any provision imposing a penalty tax, where there had been a failure to distribute earnings among shareholders, applied to all corporations, including personal holding corporations. It was stated in the earlier acts that the existence of a mere holding or investment corporation was prima facie evidence of intent to avoid the imposition of the surtax.

The 1934 Act, as has been mentioned repeatedly in the course of the tax conference, now deals with the personal holding corporation (as defined in the Act) separately and distinctly for other corporations. Different sections of the law apply to it. The application of the surtax to personal holding companies will be much more automatic, although I imagine that many cases will arise involving the question of whether a corporation is a personal holding company within the meaning of section 351.

Section 102 of the 1934 Act, however, continues the general theory of the provisions in previous acts, although it reduces the rates of tax, and also introduces a new element in the computation which makes the determination and the imposition of the tax much fairer than under previous acts. The dividends actually paid during the year by the taxpayer corporation are to be deducted from the net income which would otherwise be subject to the tax.

I shall not go into the computation of the surtax but shall suggest some of the factors or circumstances that should be considered in determining whether in a given case the corporation may be subject to this penalty tax. I assume that many accountants have been hearing from their clients who are concerned as to whether their position is such that the penalty tax may be applied.

Considers Penalty Tax Provided by Section 102

Let us assume that we are asked to determine, or to advise in a given case, whether a company seems to be open to the penalty tax provided by section 102. Among the factors that might well be considered would be:

1. Amount of earned surplus (including any transfers theretofore made from surplus to capital stock) and amount of any reserves of a contingent nature that in substance represent merely a segregation of surplus.

2. Amount of depreciation reserves. I think there is some basis for argument that a corporation which has a substantial depreciation reserve may have properly a part, or perhaps even all, of that reserve invested in marketable securities so that when large replacements have to be made it will have that reserve available for use.

3. Character of investment of surplus and depreciation reserve.

4. Number of shareholders, and especially the number of shares held by directors and officers. Whether or not stock is listed and actively traded in on an exchange or otherwise.

I think in the case of most listed companies the Treasury is very unlikely to succeed in attempting to assert this penalty tax. It would be rather difficult, it seems to me, for the Treasury to show, in the case of a company with widely distributed stock holdings, the stock listed on a stock exchange, with published financial statements, and with stockholders possibly bringing pressure for dividends, that the corporation either had been formed or was being availed of to prevent the imposition of surtaxes on the shareholders by withholding earnings from distribution.

5. Character of income: whether (a) of personal holding character, or (b) of industrial, mercantile or other business character, and respective amounts of each.

6. The present or future building or expansion policy and any contemplated advertising plans or similar plans that would require substantial expenditures. It might be necessary to hold considerable amounts of cash or marketable securities with a view to their future use for such business purposes.

What I have just indicated would apply particularly to corporations selling highly competitive articles. In some cases a corporation may be contemplating a policy of reducing sales prices to increase sales volume and attract new customers' accounts. Together with higher material and labor costs, this policy might for a time result in heavy losses that would require extraordinary cash resources.

7. Comparison of surplus in prior years with present amount of surplus.

8. Comparison of volume of business in past years with present volume and with that which may be expected in the future. That is an especially important consideration in view of greatly decreased business volume during the depression. For instance, if five years ago a corporation was doing half as much again or twice as much business in volume of dollars as it is doing today, it obviously does not need all the working capital today that it did to carry on the larger volume of business. Is it not reasonable to hope that the time is coming when the corporation may do again a considerably increased volume of business over that done in these depressed times, and when that time arrives it will need the working capital that is temporarily idle?

9. Past and present dividend policy. If a company has a substantial surplus and currently is earning profits, the payment of reasonable dividends obviously is desirable.

10. Consideration of consolidated status where there are affiliated companies which the parent may be required to finance and assist.

11. The history of the formation of the company for the purposes of ascertaining whether or not it may have been organized for the purpose of avoiding surtaxes.

12. Review of past earnings to ascertain if it is a business in which there are hazards and contingencies and, if substantial losses were incurred in prior years, whether or not such losses may recur which would require the maintenance of a substantial amount of surplus in readily available form.

13. Ascertain if securities and other assets have been written down to market value, and if not, ascertain the effect such write-down would have on the surplus. Obviously, the amount of such a write-down would not be distributable surplus. Ordinarily, this may not apply to the plant of a going concern but consideration might well be given to any such shrinkage in plant value, especially in states like New York where the law requires that dividends shall not be paid unless the value of the remaining assets equals the corporation's capital stock and liabilities. Conversely, if the assets have been written down to a nominal value merely as a matter of conservative policy, ascertain the effect on surplus of a restoration of the value of such assets.

14. Borrowings by stockholders. This is an important point. In several of the cases involving the application of corresponding sections of the previous acts that have been decided by the courts in the last year or two, the borrowings by stockholders were considered as in the nature of evidence of an endeavor or intent to avoid the imposition of surtax on the stockholders.

It must be emphasized that this whole question of the application of section 102 is one of opinion and of judgment, and naturally we should advise our clients to put themselves in such a position that under no fair interpretation of the applicable provision should they be subject to the tax. On the other hand, I think many concerns have been alarmed rather needlessly. We should give comfort where it properly can be given.

Transactions in Corporation's Own Stock

An important decision which reversed the Treasury's practice of many years standing, or rather its interpretation of the law, relates to gain or loss on the sale of the corporation's own stock. I shall not discuss this at length because I think it was referred to in some of the previous discussions of the tax conference. It is important, however, because for a period, I should say, of over fifteen years the Treasury had a provision in its regulations that gain or loss on dealings in the corporation's own stock was not either taxable (if a gain) or deductible (if a loss).

The decision of the court in the *Woods Machine Co.* case (57 F (2d) 635; certiorari denied 53 S. Ct. 15) has caused both the Treasury and the Board of Tax Appeals to reverse their former positions very drastically and the regulations have now been amended so as to read as follows:

"Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

"But where a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of applicable statutes."

Expenses

I note that the Board of Tax Appeals in a recent case held that payments made by a taxpayer to an employee of a company, for which it was laying pipe lines under contract, for the purpose of securing relief from arbitrary and impending demands of the company's inspectors and the prompt delivery of materials were not deductible as ordinary and necessary expenses (*Kelly-Dempsey & Co.* v. *Com'r*) (31 B.T.A. 74).

Closing Agreements

I call attention to the fact that the Treasury appears to have completely changed its policy with regard to closing agreements. You will remember that for quite a period of time revenue agents were eager to secure closing agreements and sometimes made the signing of a closing agreement a condition to the allowance of a debatable item.

But now in mimeograph 4149 (XIII-9-6679), it is stated that generally no closing agreement will be accepted except where there appears to be advantage in having the case permanently closed, usually in cases where there have been mutual concessions in the settlement of the case. It is stated, however, that closing agreements will be accepted where the taxpayer can show sound business or policy reasons for desiring a closing agreement and the government will sustain no disadvantage. The mimeograph gives the following example of cases in this class:

1. Where an estate fiduciary wishes to facilitate his discharge by the court.
2. Where the liquidation of corporations in dissolution will be facilitated.
3. Where creditors demand evidence of final closing of tax liability.
4. Where taxpayers desire to follow the consistent practice of closing returns from year to year.

The closing agreement, as formerly, is subject to approval by the secretary of the Treasury or the under-secretary.

This new closing agreement policy is an interesting indication of how the tide rises and falls in matters of this kind.

Also, I call your attention to the new compromise policy of the Treasury. The requesting of opinions by the Treasury and the submission thereof by the attorney-general has been going on, apparently, for a year or more, but it is only in a recent Internal Revenue Bulletin (XIII-47) that the new policy is set forth and the correspondence disclosed that had been going on between the Treasury and the attorney-general.

I also call your attention, without stopping to dwell on it, to the revised Department Circular No. 230 with respect to enrollment and disbarment. There are a number of things in that of decided interest. The Society hopes to receive shortly from the Committee an opinion on several points which have raised doubts in the minds of our members.

From an address presented at the 1934 conference on income taxation of the New York State Society of Certified Public Accountants.

Vital Need of Private Examination of Banks

By GEORGE V. MCLAUGHLIN

AT the December 17, 1934 meeting of the New York State Society of Certified Public Accountants, I stressed the vital need for private examinations of banks by independent accountants. This is an important subject and one that calls for the focusing of attention on certain outstanding points, the significance of which should be examined carefully. In the subjoined outline, I have attempted to set forth what seem to me to be the cardinal points of this subject.

I. *Recent Increase in Number of Bank Examinations*

(a) Due largely to requirements of public authorities—FDIC and RFC now have right to examine.

(b) Many banks now examined six times a year.

II. *Private Examinations, Nevertheless, More Important Than Ever Before*

(a) Bank directors now take their responsibilities more seriously. Their need for information, therefore, is greater.

1. During prosperous times, banks seem to run themselves; directorships then are often considered mostly honorary.
2. Recent events and laws have changed the attitude of directors to one of great caution.

(b) Physical impossibility of directors of large institution to make examination themselves.

1. Directors have neither time nor technical training necessary to do it.
2. Impossible for directors to digest mass of new law and regulations governing banking because they are usually engaged in some other business.

(c) It is a mistake for directors of small institutions to attempt to make their own examinations.

1. Independent viewpoint needed.
2. Technical knowledge of accountant needed, no matter how small the bank may be.

III. *Private Examinations Should Cover All Activities of the Bank*

(a) Trust department, when there is one, should be examined in order that directors' information may be complete.

IV. *While Directors are Entitled to All Possible Information, General Public is Not*

(a) Business of banks is by nature personal and confidential, as contrasted with impersonal nature of business done by industrial and public utility companies.

(b) Publication of contents of a report covering the examination of a bank is likely to embarrass customers.

V. *Condensed Statement of Condition Intelligible to Layman is Ideal*

(a) Canadian bank statements longer than ours, but furnish no more information, and are less understandable.

(b) Too much detailed information in bank statements may encourage "window dressing."

VI. *Fewer and More Thorough Bank Examinations Should Be Our Goal*

(a) Coordination of examinations to eliminate duplication and waste motion should be brought about.

(b) Too many examinations leads to competition in stringency between examiners—each group is afraid they will overlook something which the next group will criticize.

(c) The time for stringent examinations is during prosperity, when most of the mistakes are made—not during depression.

(d) To make an ideal examination, the examiner should not permit his judgment to be swayed by public sentiment or prevailing psychology.

Need for Examination of Banks by Accountants

By FREDERICK H. HURDMAN, C. P. A.

BEFORE launching into a discussion of some of the practical phases of the subject of bank examinations, I should like to make a few general observations which have a bearing on the important topic.

For many years the accounting profession has occupied an increasingly important position in the life of that part of the business community devoted to trade and industry. At first its work was concerned largely with the detection of errors in bookkeeping and uncovering defalcations. As the accountant became better equipped through training and experience, his importance in the business community increased.

Today, it is unusual to find an undertaking of any importance in the industrial world in which the professional accountant is not called upon for some measure of advice or guidance. This reflects the increasing responsibility which has been placed upon him by those extending credit and by the public in general. Today his work is almost indispensable to the credit department of a bank. The Federal Government now requires that the accountant shall interpret those facts which should be presented to the public in connection with corporate affairs.

I believe it safe, therefore, to say that the professional accountant is now a necessary link between industry, the banker and the public. In England and Scotland, the value of the accountant in the conduct of sound business has been recognized for many years. But today in the United States, at least in some respects, he occupies a position of greater importance than the older countries.

This is as it should be in a young country where initiative has, in the past at least, been given its head. Here, the accounting profession has endeavored, at all times, to keep pace with changing conditions and so has been of incalculable assistance to business growth and development. The work of the accountant has not been limited to interpreting the financial position and operating results of business enterprises for the banker and the public. He has assisted management in working out plans of consolidation and reorganization, in adapting systems of accounting to changing methods of doing business, and has presented the results of business transactions to management in such form as to permit intelligent direction of affairs.

I do not propose to offer an opinion on the adequacy of compensation received by the profession for the vital part it has played in the development of business organization and methods. Unquestionably industry has received benefits far beyond the expense incurred. Bankers and the public have profited gratuitously by reason of these services.

Considers Bankers' Inconsistency Regarding Accountants

It is interesting to note that during the period of development the banker has gradually come to recognize the value of the accountant to his customers. Has he been consistent in his recognition of the value of accountants' services?

Has he considered how these services might benefit his own affairs? I think not.

In searching for a reason for such inconsistency, I have asked myself the following questions:

1. Is it because the banker believes that although the accountant is qualified to assist all other types of business some omission in his training or equipment leaves him unable to be of assistance in connection with operating a bank?
2. Is it because he thinks that the present examinations by governmental departments furnish him with everything that he should have or might expect to get from the professional accountant?
3. Is it because he hesitates to add one more item of expense even though that item might produce for him and his board information which would enable him to return to the stockholders larger profits than they had received in the past?
4. Is it because he fears the result of a full disclosure of the bank's affairs though he always demands such a disclosure in relation to borrowers?

I do not wish to infer that bankers have ignored the accounting profession in the examination of their institutions or in the solution of problems arising in the operation of their banks. However, it is safe to say that the type of examination with which the banker has been satisfied has been inferior to that generally demanded for industry. The banker's attitude is the more remarkable when we consider the important part he has played in determining the kind of examination needed by industry.

Generally speaking, the type of examination which the banker has asked of the accountant has been one which would consume a minimum of time and cost the least amount of money.

The banker has considered the examination by the committee of directors as something approaching a nuisance, in view of the fact that his bank is also examined by a governmental agency. He has recognized that the committee is composed of busy men and that they should not be asked to count cash, scrutinize loans and securities and do the hundred tasks necessary to even a limited examination of the bank's condition. So the accountant is called in. Though he is asked to verify the figures on the bank's statement, the attitude of the banker frequently indicates that he thinks the accountant is only performing routine acts which do not warrant more than a nominal charge. Actually the accountant is assuming responsibilities for which he should be compensated adequately.

Accountant's Attitude Towards Examination is Important

If the accountant adopts the attitude of the banker and undertakes his assignment without full recognition of its implications and responsibilities, his report may fall far short of the needs of the trustees who are relying on him to furnish a full and complete statement of the bank's affairs.

It is obvious that the obligation on the banker for a thorough audit of his institution is actually greater than the obligation upon industry. Bankers are probably about the only class who boast of the amount of money they owe. I refer to the deposit liability. An industrial corporation, with a comparable debt, probably would be obliged to have its accounts authenticated by some reputable firm of accountants.

It is not sufficient for the banker to rely solely on examinations conducted by some governmental agency. Their insufficiency has been emphasized by the events of the past few years. These same events have had a decided effect in impressing upon directors of commercial banks and trust companies, and upon the trustees of savings banks, a keener and fuller appreciation of their duties and responsibilities. To directors and trustees who are conscientious in the discharge of their duties, this responsibility has been the cause of much concern and serious thinking. I know that there are banks which today are faced with a difficult problem in securing responsible business men who are willing to serve on their boards.

This situation constitutes a challenge which calls for thought. It strikes at the very foundation of our banking structure — confidence on the part of depositors — the public. If a banking institution publicly avowed that its business was to be wholly administered by executive officers it would not long retain the confidence of depositors or stockholders. The wisdom of delegating the management of a bank to a board of experienced business men of sound judgment, who recognize their responsibilities, cannot be questioned. The success or failure of a bank depends very largely upon the extent to which its directors or trustees exercise good judgment in the administration of its affairs and are vigilant in supervising its activities.

Recent trends toward government control of banking cannot minimize this. Indeed, the prospect of political interference only emphasizes the need for strong and wise directorates to forestall unsound banking. If politicians are given any voice in these matters it must be anticipated that they will seek to avoid all responsibility and lay the blame for mistakes on the directorate.

Value of Furnishing Directors with Full Information

In view of these things, let us consider what steps may be taken to reassure bank directors and trustees who now hold office and those who may be invited to serve on the boards of financial institutions. I believe that these men must know that in the future they will be furnished with complete information as to the bank's affairs. Only by this means can they exercise intelligent supervision and acquit themselves of their responsibilities in a satisfactory manner.

For obvious reasons it will be necessary to continue the periodic examinations which are now conducted by governmental agencies. We cannot hope to dispense with these examinations if Federal and state authorities are to exercise the control over these banks which is required by law. I believe that the lack of a clear understanding of the purpose and scope of these examinations has led trustees to rely upon them for a degree of protection which they were not intended to afford. The primary purpose of the Federal or state examination has been to show that an institution was or was not solvent, to call to the attention of the directors or trustees unsound loans or investments and to see that provisions of the law with respect to the operation of these banks had not been violated.

These examinations were not intended to assist or direct the board in the performance of its regular duties, although they did criticise certain actions and point out what particular sections of the law, if any, had been violated. I have been informed reliably that many bank examiners hesitate to advise a bank as

to the adoption of some specific policies, fearing that they might be confronted later by a reminder of such advice to their own embarrassment.

The law in New York State requires that these examinations be supplemented by independent examinations at specified intervals by a committee representing the board, with or without the assistance of qualified accountants. While the national banking act does not specifically require such examinations, the by-laws usually contain such provision.

The government examiner is not subject to the direction of nor does he take instructions from the board, so unless the directors, through their own representative, arrange for an examination which will produce a report directed to them covering all of the phases of the bank's operation on which they should be informed, they may never possess sufficient data to enable them intelligently to formulate policies or direct the affairs of the institution for which they are responsible. It is not sufficient that information be supplied by the officers of the bank. Self interest may deter those officers from making a full disclosure.

Limitations of Governmental Examinations

In recent years, because of the publicity given to bank failures and weaknesses disclosed in our banking system, much criticism has been leveled at the type of bank examination made by governmental agencies. In some instances this criticism may have been justified. It has been my general observation, however, that these examinations, within their scope, were well conducted and provided a valuable contribution toward the information necessary for the proper conduct of banks. They also served, in most instances, as a salutary brake on practices which, if continued, would have been damaging. But, because these examinations were conducted by a governmental bureau, the tendency was generally to assume if a condition or practice was not criticized by an examiner that it was entirely proper to perpetuate that condition or practice. By reason of this attitude, the directors, in many cases, were lulled into a state of apathy.

A growing number of directors are reaching the conclusion that it is a mistake to lean too heavily on governmental examinations and recognize the increasing importance of the examination required from the board's committee. The fact that the time of these directors is limited and that they are not by training capable of making a thorough examination has led many to seek other agencies to perform this duty. This tendency has been strengthened, in many instances, by a realization on the part of directors that in the past transactions have been approved by them without the slightest personal knowledge as to such transactions and without a deepening sense of the very definite financial liability incurred.

The obligation of the directors to see that the examination by its committee is not a perfunctory one is emphasized in a pamphlet issued by the comptroller of the currency. In this pamphlet, which is written for the information of directors of national banks and is largely devoted to a comprehensive plan for the conduct of examinations, the comptroller says that "an examination twice a year by a committee of directors, or by accountants at the instance of the board, who will give sufficient time to the work to make it thorough and complete, cannot fail to be of great benefit to all concerned, and this the directors owe to the shareholders who

have placed them in positions of trust." I should like to add to this statement of the comptroller that the directors owe it also to depositors and to themselves.

With an awakening sense of responsibility and consciousness of personal liability, directors have, in many cases, turned to the public accountant. They have realized, perhaps tardily, a new significance in what the accountant has done for industry and have envisioned his possible usefulness in the banking field.

I do not propose to attempt to detail all of the matters on which accountants can render advice to bankers nor to outline a program for the examination of banks. I shall, however, make a few observations with the hope of indicating some of the benefits which would follow were the accounting profession to acquire a position in the banking world similar to that which they now hold in the industrial field. Before doing so, however, a few suggestions to accountants may be in order.

Advice to Accountants on Bank Examinations

If the accountant is to realize the possibilities of the situation, he must first overcome the tendency on the part of bank officers and directors, which has been noted in industrial corporations, to engage accountants to assist them in their examinations and then to limit unduly the scope of the work to be done. Such restrictions greatly lessen the value to be derived from an examination.

At this point let me state that the progress of the profession in the banking field will be slow unless those who undertake the work equip themselves properly for their task. To the accountant who will not take the time necessary to understand the workings of each department of the bank my advice is to pass up this class of work until the knowledge has been acquired. It is not only necessary that the accountant shall possess specific knowledge and experience in the banking field, but it is extremely important that he should have a competent and adequate staff of assistants.

The start of the accountant's examination is of the utmost importance. At that moment he must obtain control of all of the assets of the bank in order to prevent substitutions. Adequate explanation should be obtained for all cash items found in the cash account and the final disposition of these items be ascertained by the examiner. In a recent examination, upon discovering that no overdrafts existed, it was found that the cash contained depositors' checks which, if they had been charged to the respective accounts, would have resulted in overdrafts which, under the law, must be reported to the directors. Balances on deposit with other banks must be verified in the same way as a similar item in an industrial audit. In this connection returned items to be charged back to depositors' accounts should be scrutinized. An investigation of such items in a comparatively recent examination disclosed a "kiting" operation which, if it had continued, would have had a serious effect on the solvency of the bank. The illegal procedure in question has been permitted by an officer without the knowledge of the president or the directors. It is good practice to secure independent confirmation of items out of the bank's possession. Receipts which may have been good at one time may not at the date of an examination furnish satisfactory evidence as to the location of securities. In the examination of collateral to loans, securities, bonds and mortgages and real estate it should be seen that title vests in the bank

or that suitable instruments are in possession by means of which title may be transferred.

The comptroller of the currency has outlined a very complete plan for the verification of loans and discounts. It is usually the item of loans and discounts which creates trouble for banks. For this reason, thoroughness in the verification and valuation of loans is an essential part of any real examination. A considerable study and analysis is required to portray the facts adequately. It involves a study of credit files, for which the accountant is eminently qualified by experience, a survey of the history of the loans, as indicated by the liability records, and the securing of reliable data with respect to securities held as collateral, which are not readily marketable. Maintenance of accurate records showing the liability of borrowers, direct and indirect, is highly important. Without such a record unnecessary difficulty will be experienced in studying loans, and officers and directors cannot properly pass judgment on those submitted for their approval nor ascertain whether or not legal limitations have been exceeded.

Believes Directors Usually Incapable of Adequate Examination

In my opinion it would be rare indeed to find a committee of directors who could make an adequate examination of loans and discounts in a bank of any size. The assembling of facts with respect to the loan account can be unquestionably most efficiently and effectively accomplished by competent accountants. A comprehensive presentation of these facts to the board is necessary to enable them to exercise their judgment on matters which it is essentially their function to review.

The method of internal control should be carefully studied. Adequate control will go a long way toward preventing manipulation of depositors' accounts, one of the most difficult items on the balance sheet for the auditor to verify satisfactorily. In a case which was brought to my attention, cashier's checks had been drawn to the order of the bank for the amount of profits realized on the sale of securities during one reporting period for the express purpose of deferring income to a later date, which income was then to be used as an offset to losses which the officer did not intend to report to the board. By a similar use of cashier's checks or certificates of deposit, it would be possible for a bank to conceal borrowings from its board and the public.

In connection with the preparation of a statement of earnings, care should be used to see that the statement actually portrays the results of operations. It is possible by an erroneous method of accruals and by the misuse of reserves for a bank to present a distorted picture of the operating results for the period under consideration.

I could comment in great detail on the various steps to be followed in the course of typical bank examinations. These steps will be obvious to those of you who are familiar with this type of examination. It would take several sessions to discuss fully the detailed procedure to be followed. To those who are inexperienced in this field my advice is to acquire sufficient knowledge of the specific problems before venturing in it and not to undertake examinations without an organization thoroughly familiar with the inside workings of a bank.

I have not mentioned the examination required for the foreign, bond or trust departments of a bank. In many cases the trust department is as large or larger than, from the standpoint of assets involved, the bank itself. Many directors have found it advisable to institute special examinations of these departments. The work of the trust department includes definite responsibilities and presents many technical problems in bookkeeping and procedure. The arguments which have been advanced in favor of a corporate trustee as against an individual trustee have been the continuity of its corporate existence, the broader scope of its experience and the facilities at its disposal. These arguments have not been justified always. Many instances have come to light in which subordinates have been entrusted with the interpretation of instruments and the making of decisions which should have been done by higher officers. The conscientious director should see that the methods employed are such as will best protect the trust placed in his institution and will install means to insure handling these trust responsibilities in the best way possible. The accountant surely by his experience is capable of making this study, of calling to the attention of the directors conditions which should be changed and of recommending the course to be adopted.

Savings Banks Slow to Appreciate Accountant's Report

Perhaps no field in the banking world has been more neglected than that of savings banks. Because these banks are mutual and the public, represented by the depositors, hold the entire stake, there is a further reason why trustees should insist on a review of the bank's affairs by their own representatives. Relatively few of these banks have availed themselves of the assistance to be rendered by independent accountants. It is my opinion that there is a growing realization on the part of savings bank trustees that accounting methods and procedure which have been in effect for many years are now out-moded and fail to meet the needs of today.

As a result of conditions arising during the past few years, savings banks now find themselves confronted with serious problems created through defaults in connection with their bond and bond and mortgage investments. Numerous foreclosures have been completed or are in process and real estate holdings of these banks have increased greatly. This has meant a distinctly new phase in savings bank activities. The problem has grown with such rapidity that savings banks have been unprepared to meet the situation. Make-shift records were at first tried but as the difficulties became more acute it was found that definite steps were required to meet it. As has been customary among banks, there was an exchange of ideas between banks handling these matters and accounting forms were adopted generally without regard to their fitness in a particular bank. Were such a situation to occur in an industrial corporation, the first step would be undoubtedly to call in accountants to advise and suggest the system best suited to care for the new condition. As a result of faulty procedure adopted by these savings banks, many of their records are inadequate and afford no proper control.

By devising adequate records for the control of income and expense in connection with real estate holdings acquired by savings banks under foreclosure, an element of weakness may be converted to an advantage. In many instances it has been demonstrated that under proper management property can be taken over,

rehabilitated and placed on a self-sustaining basis, and actually become a better investment than the bank formerly had in its bond and mortgage loan.

The trustee of a savings bank occupies, if anything, a position of greater trust and responsibility than does the director in a commercial bank. There is all the more reason, therefore, why he should be fully informed by someone independent of the management if he is to administer faithfully and efficiently the trust imposed upon him when he accepted his appointment.

A few concrete cases which have come to my knowledge during the past year may illustrate more clearly than anything I have said the position which, in my opinion, the accountant should attain in his relations to the banking world.

Cites Instances Where Accountants Rendered Vital Service

A director of a national bank, realizing that he knew very little about his institution or what was going on, convinced the other members of the board that competent advice should be obtained from the outside. A firm of accountants was retained to make a thorough investigation of the bank, its policies and its personnel. A report was made which showed a financial condition much more serious than suspected by any director. Knowledge of the actual situation could not have been gained readily from a study of the report of the national bank examiner. The system employed was wholly inadequate. Definite recommendations were made for changes to insure the greatest protection to the bank and the production of adequate and reliable information for the guidance of the board, and were made also with respect to the personnel. After due consideration by the whole board, at a meeting attended by a representative of the accounting firm, a free hand was given to that firm to revise the system and institute suitable reforms. Active steps were taken to reorganize the personnel and generally to conduct the affairs of the bank in a manner consistent with the best practice among first grade institutions.

An officer of another banking institution asked a firm of accountants to look over the form of financial report which that bank had been rendering for years to their board. It was found that this so-called financial report was nothing more than a trial balance showing asset and expense accounts as of a given date in comparison with the previous year. On a separate sheet the liabilities and income accounts were compared with those of the previous year. A simple rearrangement of the items to bring out significant totals and a segregation of income and expense accounts to show the operating results was all that was needed to convert an otherwise meaningless statement into a report of some value to the directors.

A savings bank, which has for years been regularly examined monthly by a firm of accountants, had on its board two men who, fully understanding their responsibilities for the first time and realizing that they were not securing all the information they should have concerning the bank, called in a firm of accountants to make an examination and report. As a result of the report that firm is not only making the examination required by law but now is called upon as consultants and asked to study conditions in connection with the operation of the bank and present facts in such a manner that the board of trustees can quickly reach con-

clusions. The firm has by its advice in one matter alone saved to the bank a large part of its annual retainer. It is interesting to note in this connection that the fee now earned by this firm greatly exceeds that paid to its predecessor.

My observations covering many years have convinced me of the following:

1. Banks have not availed themselves of the service of certified public accountants to anything like the extent comparable with that of industrial corporations.
2. I am confident that a greater use by banks of the services of certified public accountants would result in benefit to the banks in a more intelligent portrayal of conditions to the end that directors would be able to direct intelligently and to the end that greater confidence would be developed by the public in the conduct of our banks. It is also evident to me that closer relations between the banker and accountant would give to the banks advantages other than those gained from intelligent reports on financial condition. Some of these advantages might be:
   (a) The discovery of weaknesses in method of internal control
   (b) Assistance in organizing and devising plans for continuous internal audit
   (c) Advice in devising and installing up-to-date systems where needed and introduction of labor saving devices
   (d) Installation of improved types of reports to be prepared by department heads for guidance of officers
   (e) Introduction of more informative reports for directors
   (f) Development of cost systems
   (g) Study of tax problems
   (h) Intelligent investigation of trust department problems
   (i) Competent and intelligent presentation of facts in connection with complicated loan situations.
3. The directors should properly appraise the examinations being conducted by governmental agencies and insist that those examinations be supplemented by investigations conducted by agencies of their own choosing who will report directly to them and be available for consultation and advice at all times.
4. The practice of conducting perfunctory examinations should be discouraged both by accountants and directors.

Presented at the December 17, 1934 meeting of the New York State Society of Certified Public Accountants.

Important Changes in the 1934 Revenue Act

By Donald Arthur, C. P. A.

A REVIEW of the 1934 Revenue Act shows that the changes, as compared with prior acts, may be roughly classified into two groups. The first group embraces changes upwards in the rates of tax—more or less justifiable to meet the needs of the government—and the second group includes the many provisions designed to patch up loop-holes, real or fancied, in prior income tax acts.

It is with this second group that accountants are most interested, particularly as the group includes radical departures from previously well established principles.

When the 1918 Revenue Act was passed it was hailed by many as being perhaps the most scientific income tax act ever enacted. It was found soon, however, that our flair for particularization in legislation made it a weak law rather than a strong one and that it opened up almost insuperable administrative difficulties.

It is quite true that enormous sums were collected successfully by the government under this and similar succeeding acts, but it is not so certain that all taxpayers were given equal consideration. Succeeding revenue acts modeled generally on the 1918 Act have been patched beyond recognition and the latest edition—the 1934 Revenue Act—is by no means an improvement on its predecessor.

It is well to deal here with a few of the more important changes which might be classified under the second group mentioned above.

Explains Need for Consolidated Returns

Many will remember that the 1917 Act, which was the first to impose heavy income and excess profits tax burdens on corporations, contained no provision at all for consolidated returns. Under that Act, however, regulations were issued by the commissioner of internal revenue which provided for such returns for excess profits tax purposes. There was considerable doubt as to the validity of the regulations, but that doubt ultimately was set at rest by a provision in the 1921 Act to the general effect that title II of the Revenue Act of 1917 "shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the year 1917."

The 1918 Act made consolidated returns for corporations mandatory for both income and excess profits tax purposes. Subsequent revenue acts up to and including the Act of 1932 provided an option in the case of affiliated corporations to file a consolidated return or separate returns. The 1934 Act, approved May 10, 1934, made no provision for consolidated returns, except in the case of railroads, so that a practice generally regarded as sound was abandoned somewhat abruptly by Congress after having been in use for a period

of seventeen years. Business was given no opportunity to adjust its affairs to the new conditions and immediately sought artificial means to meet, if possible, the government's somewhat unfair change of position.

It may be worth while to say that the bill as originally introduced (February 9, 1934) contained a provision giving affiliated corporations the privilege of filing consolidated returns. In successive printings of the bill filed in the House and Senate the provision was allowed to stand. In the report of the House, Ways and Means Committee dated February 12, 1934, various reasons were given justifying its retention, even though the subcommittee had originally recommended abolishing the consolidated return. Among other favorable reasons, were the following:

> For all practical purposes, the various subsidiaries, though technically distinct entities, are actually branches or departments of one enterprise.
>
> The administration of the income tax law is simpler with the consolidated return since it conforms to ordinary business practice, enables the Treasury to deal with a single taxpayer instead of many subsidiaries, and eliminates the necessity of examining the bona fides of thousands of inter-company transactions.

In this report it was recommended that an additional tax of two per cent be levied on corporations availing themselves of the privilege of filing consolidated returns but it is difficult to find justification for this penalty. In the report of the Senate Committee on Finance dated March 28, 1934, the committee quoted "in extenso" from the report of the Ways and Means Committee and recommended adopting the provisions of the House bill practically in their entirety.

Regarding Congressional Committee Reports Preceding 1934 Act

Subsequently, the provision was thrown out on the floor of the Senate and its rejection was agreed to in conference, despite serious efforts on the part of the Treasury and others to have it retained. Among the considerations stated in the above mentioned report of the Ways and Means Committee against the consolidated return are the following:

> It cannot be denied that the privilege of filing consolidated returns is of substantial benefit to the large groups of corporations in existence in this country. This is true especially in depression years, for the effect of the consolidated return is to allow the loss of one corporation to reduce the net income and tax of another, and during a depression more losses occur. Another effect of the consolidated return may be to postpone tax. This is because there is no profit recognized for tax purposes on inter-company transactions, and profits on a product of the consolidated group, passing through the hands of the different members of the group, are not taxed until the product is disposed of to persons outside the group.

Talking to such an intelligent and well-informed group as the New York State Society of Certified Public Accountants, it may be permitted to suggest that such arguments are unsound entirely. As a matter of fact, coupled with the arguments in favor of retention, already quoted from the same document, they simply are contradictory.

Congress in its eagerness to obtain a doubtful gain, has upset ruthlessly a business and accounting practice which has been in existence in this country for the best part of half a century, and which, for tax purposes, has been recognized for seventeen years. Some of the results of this action are; first, the practical destruction of the usefulness of a considerable body of highly trained men in Washington who have learned to audit consolidated returns and have become quite good accountants; second, the routine work of the Treasury has been increased unduly due to the enormous increase in the number of corporation returns which will be filed and will have to be examined separately; third, and perhaps the most important, a great number of large groups of affiliated corporations have been forced unnecessarily either to merge and dissolve members of their group which consistently operated at a loss or to employ artificial means through inter-company transactions in order to insure as far as possible that the aggregate tax paid by the group will be no greater than would have been the case had consolidated returns been permitted; fourth, there is to be considered the very material increase in the work of the corporations in preparing many additional returns.

These necessities may not be unproductive of good in a great number of cases as there is no doubt that generally speaking the business of an affiliated group could be carried out successfully within the shell of one or two corporations rather than through the medium of many. On the other hand, it is true that there are valid reasons for the existence of subsidiaries, such as in simplifying the carrying on of business in the several states and also in simplifying the question of state taxes.

It may be said fairly that whether or not affiliated corporations should be allowed to file consolidated returns, they should have been permitted to do so at least for the year 1934 in order that business might have had a chance to correct situations which have been allowed to exist without thought of tax savings, but which, on the basis of separate returns, result in higher taxes to the group as a whole, a result it would seem hard to defend on any basis of equity.

Problems Raised by Limiting Consolidated Returns

It might be pertinent to point out that as the matter now stands both taxpayer and government have some knotty problems to solve. Among them are the following:

1. Take the simple case of a parent manufacturing company selling all of its product to a selling subsidiary at prices including the inter-company manufacturing profit. Assume that these companies made a consolidated return for 1933; then the inter-company profit would be eliminated from the inventory in that return. Under the provisions of section 113 (a) (11) of the 1934 Act the subsidiary company would be required to commence 1934 with its inventory basis at cost to the parent company, so that the subsidiary's profit for 1934, assuming all of the inventory were sold in that year, would include the inter-company profit which formerly was designed to be the profit of the parent company.

While the above would seem to follow for federal tax purposes, does it also follow for state tax purposes and, if so, would it not be contrary to the decision in the Underwood Typewriter case (254 U. S. 113)? In that case, a portion of the profit was assigned to the manufacturing company and a portion to the selling company. That case involved taxation in Connecticut.

Let us follow this a step further; the subsidiary company's profits having been increased by the inter-company profit within the year 1934, its net worth would be increased correspondingly, so that if the company were dissolved, it is conceivable that the parent company would be taxed again on this same amount.

2. To what extent and with what justification will the Treasury now examine into the basis of inter-company transactions and to what extent may the commissioner invoke section 45 of the Act to produce greater taxes without invoking it to alleviate a burden such as indicated in (1) above?

3. There is the question of interest on inter-company borrowings. Where no interest is customarily charged it is possible that the government might assert that on a separate company basis the lending company has constructively received interest and thus increased its income under circumstances where the borrowing company operating at a loss would obtain no advantage from a deduction for the same interest. You are aware probably that this situation has arisen in Canada and is incorporated in the present Canadian income tax act in a provision (section 23-a) giving the minister power in case of non-interest bearing advances by a Canadian company to a non-resident company to determine the amount of interest on such advances which shall be deemed to have been received by the Canadian company. There is some justification for the Canadian rule but if it were extended in this country to apply to inter-company borrowings of domestic companies much injustice probably would result.

4. And then there are remaining the complicated situations arising out of merger, consolidation and sale which may or may not be affected by the change in status due to congressional action in placing affiliated corporations on a separate footing when heretofore their corporate sanctity was unimportant to a large extent.

The extreme injustice of denying the right of consolidation to affiliated corporations is magnified by the retention of the right on the part of the commissioner under section 45 of the Act to consolidate affiliated corporations whenever he thinks it proper to do so.

Analyzes Change in Definition of a Reorganization

An important change has taken place in the definition of a reorganization. In prior acts the term meant "merger or consolidation" including the acquisition by one corporation of a majority of the voting stock and a majority of the total number of shares of another corporation or substantially all the properties of another corporation. Under the present law the term "reorganization" means "(a) a *statutory* merger or consolidation, or (b) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least eighty per cent of the voting stock and at least eighty per cent of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation."

Sub-headings (b), (c) and (d) of the prior Act are retained under sub-headings (c), (d) and (e) of the present Act.

Under the new definition "mergers" and "consolidations" are treated separately from other types of reorganization, and the terms are confined to "statutory" mergers and consolidations. The acquisition by one corporation of the required amount of stock or properties of another corporation is not now included within the terms "merger or consolidation" but is separately stated to constitute a reorganization. However, the acquisition of stock must represent eighty per cent of all classes, and the acquisition of either stock or properties apparently must be solely in exchange for voting stock of the acquiring corporation.

The definition of "a party to a reorganization" which is not all inclusive, has been expanded for clarification to include both corporations in the case of a reorganization resulting from the acquisition by one corporation of the *properties* as well as the stock of another.

Questions of reorganization have always been difficult; each individual case has had to be considered by itself. Whether the changes in the definition of a reorganization will make the subject more or less complicated it is difficult yet to determine. We must await not only the new regulations, but some experiences in the application of the new provisions.

Effects of Capital Gains Tax Described

Whether capital gains should ever have been the subject of tax is a moot question; valid arguments have been offered on both sides. Whatever be the correct answer, it must be admitted that the existence of a tax on capital gains has from time to time had a deterring effect on the movement of capital. Similarly, the allowance of capital losses as a reduction from ordinary income must at times—particularly towards each year-end—have had a depressing effect and possibly a distorting effect on stock market prices. It is perhaps too much to hope that such gains and losses will be removed ultimately from the tax sphere. It is certainly unjust that the gains should be added to ordinary income and taxable in the upper brackets and losses should not be allowed in mitigation, except against similar gains. If, in order to equalize the situation the taxpayer sees to it that his losses each year equal his gains then he is a shrewd man indeed if he expects to get ahead. Few, if any, are impressed with the congressional view that the time element has much to do with the character of the gain. If it has anything to do with it, then most of us probably would favor the two-year period coupled with a reasonable rate of tax materially lower than that on ordinary income, as being preferable to the progressive periods set forth in the present law. It is true, of course, that the constitutional amendment gave power to Congress to tax income from whatever source derived, but it seems clear that Congress under that amendment had the right to define income to the exclusion of capital gains.

It is also true that, once income has been defined, Congress has the power to allow or disallow deductions therefrom as it sees fit, so that we are left with the complaint that the present action of Congress is an example, of which, unfortunately, there are too many, of failure to play the game.

In passing it is fair to say that taxation has become largely a battle of wits between the taxpayers and Congress and it is, therefore, probably unfair to accuse Congress of unjustifiable methods in raising the necessary taxes without also saying that in many instances the taxpayers themselves are responsible in considerable measure.

It may be proper to suggest that the New York State Society, through its highly efficient tax committee, should study further this important problem and make recommendations towards its satisfactory solution. None can say that the situation under the 1934 Act is either scientific or fair.

Since all assets, other than stock in trade and inventoriable assets, are now designated as capital assets, and since there is a limitation on the amount of loss in disposition of capital assets which may be availed of, corporations are now affected in a manner from which they were immune under the prior acts. For instance, if a corporation now disposes of a capital asset by sale and a loss results, that loss is available only to the extent of capital gains within the year plus the sum of $2,000. It becomes important, therefore, for corporations to decide whether it may be preferable to abandon an asset rather than sell it, and even here the benefit of the loss being obtained depends upon the method of ultimate disposition of the property.

Linking of Capital Stock and Excess Profits Tax Decried

All of us have encountered capital stock and excess profits taxes before but never in the weird shape that has sprung back on us in the form first stated in the National Industrial Recovery Act and repeated in the present income tax act.

No reasonable person, in an emergency, can have much quarrel with either tax, but when the two taxes are hooked up in such a manner as to produce a guessing contest then we can have little sympathy with the fathers of the idea. One is reminded of the admonition of Adam Smith:

> "The tax which each individual is bound to pay ought to be *certain,* and not arbitrary. The time of payment, the manner of payment, *the quantity to be paid, ought all to be clear and plain to the contributor,* and to every other person. . . . The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty."

These words are as true in the field of taxation today as when they were uttered 158 years ago. The only certain thing about this twin abortion (by whomsoever it was conceived) is that practically no one can make a guess which will result in paying the *correct* amount of the combined taxes.

With the present set-up covering these two taxes, one guesses what profits will be for, say the next five years, and thereupon one pays a modest

enough tax on a sum equal to the capitalization of these profits on a twelve and a half per cent basis. Instead of making the anticipated profits, however, losses result for, say the succeeding two years. No excess profits taxes become payable. The losses go to reduce the declared value and thus the exemption—so that, should the anticipated annual profit be earned in the third year, an excess profits tax probably results. In other words, it is quite possible that a corporation—acting in good faith—will incur greater taxes by making losses.

There is no doubt that many incongruous results will emerge from this superficially self-correcting type of tax legislation. For instance, in the case of a holding company whose income consists of dividends received from subsidiaries, it is obvious that under the terms of the Act that company is entitled to declare no value for its capital stock. If, however, during the succeeding year the parent company acquires the stock of additional subsidiaries in consideration of an issue of its own stock, then in such succeeding year it will be required to declare values for these additional subsidiaries. So that on one part of its assets it would be exempt, in effect, from capital stock tax, whereas on another part of exactly similar assets it would be required to pay a capital stock tax. In the example I am giving I am assuming that this particular holding company would not be exempt from capital stock tax under the Act.

Section 102 takes the place of section 104 of the prior Act. The tax of fifty per cent is changed to twenty-five per cent on the first $100,000 of adjusted net income, plus thirty-five per cent of the amount of adjusted net income in excess of $100,000. The purpose is broadened to include not only the shareholders of the corporation, but the shareholders of any other corporation, so that the tax may not be escaped by setting up a second corporation. Dividends paid during the taxable year are permitted to be deducted from the net income before applying the rates proposed by section 102. The important point in this connection is not so much the changes, but the fact that the present administration is, for the first time, making a definite drive to apply the provisions of the section and collect tax.

Personal Holding Companies

The provision concerning personal holding companies finds its place in the 1934 Act for the first time. It imposes a tax of thirty per cent on the undistributed adjusted net income not in excess of $100,000, plus forty per cent of the amount thereof in excess of $100,000.

To qualify as a personal holding company, eighty per cent of the gross income for the taxable year must be derived from royalties, dividends, interest, annuities and gains from the sale of stock or securities. Further, during the second half of the year more than fifty per cent in value of its outstanding stock must be owned directly or indirectly by or for not more than five individuals. The various provisions covering this special tax on the personal holding corporation are carefully spelled out in section 351 of the Act. The same provision giving election to payment of surtax by the stockholders is

included as is the case under provisions of section 102, so that in the case of individuals owning the bulk of the stock of the personal holding corporation and having large income from other sources it is apparent that they may allow their personal holding corporation to suffer the taxes imposed by section 351, rather than avail themselves of the option.

Curiously enough in the computation of its net income under section 351 the corporation is permitted to deduct Federal income and excess profits taxes paid or accrued, whereas that is not the case under section 102. There are also other deductions in favor of the personal holding corporaton as compared with the commercial corporation subject to section 102.

Returns as Public Records

We all know that Congress has been flirting for years with the idea of making returns a matter of public record and actually put it into effect for 1926. It is again with us and the most that can be said for it is that it creates a further source of annoyance to taxpayers from ambitious advertisers and in many instances may put taxpayers in jeopardy from that element of the community now apparently operating so successfully in the kidnapping game.

Under the administrative provisions of the Act perhaps the most important departure from the immediately prior acts is that the government will have three years instead of two from the time of filing the return for starting proceedings for assessment and collection of tax by the mailing of a deficiency notice.

There are, of course, many other changes in the 1934 Act as compared with prior acts, but they have been adequately covered in the tax services and need no special comment.

There are two main difficulties with our federal income tax system, both finding their genesis in political considerations. The first is that in an apparent attempt to attain perfection an ostensible effort has been made in drafting the laws to cover every conceivable situation that might arise, and this has had a limiting effect, leaving no room for the use of good horse sense. Powerful political lobbies have furthered this type of legislation since it has enabled them, in many instances, to slip in affirmative provisions or exceptions favoring their particular industry. A second is that those charged with the administration of the law are so hedged about by checks and counterchecks that, despite their protests to the contrary, the actual administration of the law has reached a point where at the present time it is almost impossible to settle a tax case involving any substantial sum of money without going to court. Undue centralization has probably a great deal to do with this difficulty and it is to be hoped that the recent study of foreign tax systems made by our Treasury Department will be productive, particularly along administrative lines.

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Authors of Articles In This Issue

WALTER A. M. COOPER of Barrow, Wade, Guthrie & Co.

❖

DR. JAMES M. LANDIS, member of the Securities and Exchange Commission.

❖

HARLAN H. HORNER, assistant commissioner for higher education of New York State.

❖

WALTER A. STAUB, president of the New York State Society of Certified Public Accountants. Member of Lybrand, Ross Bros. & Montgomery.

❖

GEORGE V. MCLAUGHLIN, president of Brooklyn Trust Company. Former superintendent of banking of New York State. Certified Public Accountant of New York.

❖

FREDERICK H. HURDMAN, first vice president of the New York State Society of Certified Public Accountants. Member of Hurdman & Cranstoun. Former president of American Institute of Accountants.

❖

DONALD ARTHUR of Price, Waterhouse & Co.



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